

Attorneys' Fees for Contractual Non-Signatories Under California Civil Code Section 1717: A Remedy in Search of a Rationale

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As the American Rule of attorneys' fees has come under attack in recent years, courts in California have eroded the effect of the Rule in contract actions pursuant to California Civil Code Section 1717, which makes contractual fee-shifting provisions reciprocal. This ad hoc approach has led to inequitable and unpredictable results. This Article proposes that the statute should be amended to clarify that contractual fee-shifting applies only to signatories to the contract.

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Let all the laws be clear, uniform and precise: to interpret laws is almost always to corrupt them.

Voltaire¹

INTRODUCTION

Under the American Rule of attorneys' fees, which prevails in California and throughout the United States, each side in a lawsuit must pay its own attorneys' fees, regardless of the outcome of the litigation. As the cost of litigating even relatively minor lawsuits has spiraled

1. A DICTIONARY OF LEGAL QUOTATIONS 18 (1987), *cited in* Harris v. Superior Court, 3 Cal. App. 4th 661, 667, 4 Cal. Rptr. 2d 564, 568 (1992).

upward,² litigants and their attorneys have become ever more enterprising and aggressive in seeking to enlarge exceptions to the American Rule in an effort to shift the burden of the prevailing parties' attorneys' fees to the losing party. Probably the largest exception to the American Rule is that which allows parties to a contract to shift attorneys' fees by agreement. In recent years, litigants in California have successfully enlarged the scope of the contractual exception to the American Rule, logically applying only to parties to an agreement, to include contractual non-signatories involved in contract actions. Ambiguous language in Civil Code section 1717, which governs awards of attorneys' fees provided for by a contractual provision, makes this incongruity possible.³

This Article examines the application of fee-shifting under Civil Code section 1717 to cases involving contractual non-signatories. A review of the background of the American Rule and the legislative history of Civil Code section 1717 reveals that the statute was never intended to allow fee-shifting in cases involving contractual non-signatories. Nevertheless, a series of appellate cases gradually extended the scope of the statute so that the fee-shifting rule now prevails in a wide range of cases involving contractual non-signatories. This Article examines the many practical and theoretical problems created by broadly applying fee-shifting under Civil Code section 1717. The focus then turns to the potential benefits of wider fee-shifting. In conclusion, this Article argues that Civil Code section 1717 should be amended to return it to its original purpose and to clarify that the statute only applies to parties to the contract in dispute.

Part I of this Article traces the development and establishment of a non-signatory's right to attorneys' fees under section 1717. This section begins with a brief discussion of the American Rule and of the contractual exception to the rule. Civil Code section 1717 was intended

2. In some cases, attorneys' fees vastly exceed the total sum in dispute. For example, in *Camporeale v. Southshore Beach and Tennis Club Apts.*, No. A057143 (Cal. Ct. App., October 19, 1994) cited in Barbara Steuart, *No Joke: \$100 Dispute Spawns More Than \$1 Million in Fees*, THE RECORDER, Oct. 21, 1994, at 1, a landlord-tenant dispute over a \$100 fee yielded an attorneys' fees award of \$422,258. See also *Deane Gardenhome Ass'n v. Denktas*, 13 Cal. App. 4th 1394, 1399, 16 Cal. Rptr. 2d 816, 817 (1993) (the monetary value of the dispute was less than \$1,800, and the court awarded attorneys' fees to the prevailing party of \$15,000).

3. CAL. CIV. CODE § 1717(a) (West Supp. 1995), discussed *infra* text accompanying notes 34-36.

mainly as a consumer protection law, enacted specifically to address fee-shifting provisions in mass contracts benefitting only the drafters. Part I traces how courts then judicially extended the effects of section 1717 well beyond this intended focus to cases involving contractual non-signatories. The California Supreme Court approved the extension of section 1717 to non-signatories in *Reynolds Metals Co. v. Alperson*.⁴ The *Reynolds* court failed, however, to cite any theoretical basis for its decision, nor did it clarify how to apply the statute in future cases.

Part II discusses the rules that have evolved since *Reynolds*, implementing fee-shifting under Civil Code section 1717 in cases involving contractual non-signatories. It begins with a description of the kinds of cases in which courts have allowed fee-shifting in favor of and against non-signatories. Discussion then turns to the theories used by the courts to justify such fee-shifting: estoppel and mutuality. Courts have applied both theories to provide an award of attorneys' fees in a wide range of cases.

Part III discusses the practical and theoretical problems with the application of fee-shifting under section 1717 to contractual non-signatories. Neither the language nor legislative purpose of the statute provides any basis for the broad fee-shifting currently permitted under section 1717. On a more practical level, the theories used to justify such fee-shifting could permit fee-shifting in many cases where the prevailing party has no legal, equitable, or contractual right to recover attorneys' fees. Because the courts properly refuse to award fees in such cases, however, the theories yield wildly inconsistent and unpredictable results in practice. Accordingly, both theories are useless tools for accurately predicting when contractual non-signatories will be subject to fee-shifting pursuant to section 1717. This confusion creates further problems for the courts and litigants, including increased litigation and lower credibility for the courts.

Part IV shifts to a survey of the arguments in favor of fee-shifting under section 1717. These include fairness, providing proper economic incentives for filing suits, punishing parties who bring frivolous suits, compensating the prevailing party, and increasing the likelihood of settlement. Analysis of each of these arguments shows that they do not provide strong support for fee-shifting under section 1717 in cases involving contractual non-signatories.

On balance, the arguments in favor of wide application of section 1717 are not as compelling as the arguments against allowing non-signatories to recover fees under a contractual provision. This Article

4. 25 Cal. 3d 124, 599 P.2d 83, 158 Cal. Rptr. 599 (1979).

proposes a legislative amendment to section 1717 limiting application of this statute to parties to the contract, thereby eliminating the raft of problems associated with applying section 1717 to contractual non-signatories.

I. THE AMERICAN RULE OF ATTORNEYS' FEES, THE ENACTMENT OF SECTION 1717, AND ITS APPLICATION TO CONTRACTUAL NON-SIGNATORIES

A. *The American Rule of Attorneys' Fees*

Before discussing section 1717 itself, it is first necessary to explain the American Rule, as well as the arguments for and against it. The American Rule is codified in California in Code of Civil Procedure section 1021.⁵ Under the American Rule, each side pays its own attorneys' fees in litigation regardless of the outcome of the lawsuit. There are three general categories of exceptions to the American Rule: contractual,⁶ statutory,⁷ and equitable.⁸ The American Rule has long

5. CAL. CIV. PROC. CODE § 1021 (West Supp. 1995) provides: "Except as attorney's fees are specifically provided for by statute, the measure and mode of compensation of attorneys and counselors at law is left to the agreement, express or implied, of the parties; but parties to actions or proceedings are entitled to their costs, as hereinafter provided."

6. *Id.*; see also *Nevin v. Salk*, 45 Cal. App. 3d 331, 338, 119 Cal. Rptr. 370, 373 (1975) (approving of contractual fee-shifting provision under § 1021); John F. Vargo, *The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice*, 42 AM. U. L. REV. 1567, 1578-79 (1993).

7. Hundreds of California statutes provide for fee-shifting, found in almost every one of the state's codes. See RICHARD M. PEARL, CALIFORNIA ATTORNEY FEE AWARDS §§ 7.1-7.14 (2d ed. 1994) (listing over 400 fee-shifting statutes); James P. Benoit, Note, *City of Burlington v. Dague: When You Wish Upon A Lodestar for Reasonable Attorney Fees*, 24 PAC. L.J. 1567, 1579 n.62 (1993) (listing over 200 fee-shifting statutes); see also Note, *State Attorney Fee-Shifting Statutes: Are We Quietly Repealing The American Rule?*, 47 LAW & CONTEMP. PROBS. 321 (1984) (noting a trend of an increased incidence of fee-shifting statutes throughout the United States and listing almost 2000 state fee-shifting statutes).

8. See *Serrano v. Priest*, 20 Cal. 3d 25, 34-43, 569 P.2d 1303, 1306-13, 141 Cal. Rptr. 315, 318-24 (1977) (setting forth three equitable exceptions in California to the American Rule: the common fund doctrine, the substantial benefit doctrine, and the private attorney general doctrine). See generally PEARL, *supra* note 7, §§ 7.1-7.14; Jineen T. Cuddy, Comment, *Fee Simple? Indeterminable: Inconsistent Procedures Regarding Attorney Fees and Posting Appeal Bonds*, 24 PAC. L.J. 141, 150-53 (1992), for a discussion of these equitable exceptions to the American Rule in California.

prevailed in California⁹ and throughout the country.¹⁰ Other nations have allowed for broad fee-shifting provisions in favor of the prevailing party. This system is commonly known as the Indemnity Rule, because the losing party indemnifies the prevailing party for her attorneys' fees,¹¹ or as the British or English Rule, because this system prevails in the United Kingdom.¹² In fact, the so-called British Rule has been adopted by most other countries in the world.¹³

Several arguments are usually interposed in favor of the American Rule. First is the concern that broad fee-shifting in all cases would discourage meritorious claims by individuals and thereby reduce their access to justice. "The American Rule is based upon the philosophy that 'one should not be penalized for merely defending or prosecuting a lawsuit, and that the poor might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included the fees of their opponents' counsel."¹⁴ This effect could be especially pronounced if a party intends to bring a test case involving new and undecided concepts of law.¹⁵ Second, fee-shifting might increase litigation costs because the increased incentive for victory and the increased costs of defeat would induce parties to commit greater

9. The American Rule was first codified in California in 1851, by Stats. 1851, c.5, § 494 at 128. See CAL. CIV. PROC. CODE § 1021, Historical Note (West 1980).

10. The American Rule has prevailed in American courts for almost as long as there have been American courts. The United States Supreme Court first enunciated the rule in *Arcambel v. Wiseman*, 3 U.S. (3 Dall.) 613 (1796), and most recently reaffirmed the rule in *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240 (1975). For a history of the American Rule, see Arthur L. Goodhart, *Costs*, 38 YALE L.J. 849, 873-77 (1929); John Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, 47 LAW & CONTEMP. PROBS. 9 (1984); Vargo, *supra* note 6, at 1570-78.

11. See Philip J. Mause, *Winner Takes All: A Re-Examination of The Indemnity System*, 55 IOWA L. REV. 26 (1969).

12. See *Fleischmann Corp. v. Maier Brewing*, 386 U.S. 714, 717 (1967); Goodhart, *supra* note 10; Herbert M. Kritzer, *Searching for Winners in A Loser Pays System*, 54 A.B.A. J. 55, 56-58 (1992); Vargo, *supra* note 6, at 1601-13, for a description of the history and practice of fee awards in the United Kingdom.

13. See Werner Pfennigstorf, *The European Experience With Attorney Fee Shifting*, 47 LAW & CONTEMP. PROBS. 37 (1984) (noting that two-way fee-shifting is the norm in Europe); Thomas D. Rowe, Jr., *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651, 651 n.1 (1982) (noting that the only other major country that follows the American Rule is Japan); Frances K. Zemans, *Fee Shifting and the Implementation of Public Policy*, 47 LAW & CONTEMP. PROBS. 187, 188 (1984) (noting that the United States is the only common law jurisdiction in which each party pays her own attorneys' fees).

14. *Young v. Redman*, 55 Cal. App. 3d 827, 835-36, 128 Cal. Rptr. 86, 91 (1976) (quoting *Fleischmann Corp. v. Maier Brewing*, 386 U.S. 714, 718 (1967)); see also *Sciarrotta v. Teaford Custom Retailing, Inc.*, 110 Cal. App. 3d 444, 452, 167 Cal. Rptr. 889, 894 (1980); 44th Annual Judicial Conference of the D.C. Circuit, 100 F.R.D. 111, 175 (1983).

15. See Rowe, *supra* note 13, at 655.

resources into each case.¹⁶ Third, fee-shifting might discourage settlement. Adding the possibility of recovering fees into the litigants' calculus of the settlement value of their cases could make settlement less likely.¹⁷ The British Rule also creates satellite litigation about the attorneys' fees themselves, further clogging the courts and adding to litigation costs.¹⁸

Numerous arguments have also been arrayed on the other side of this debate, in favor of the British Rule. First, it is unfair for prevailing parties to pay their own attorneys' fees when the fees can legitimately be described as an element of damages. Litigation will not make prevailing parties whole when they bear the burden of paying their own attorneys' fees because such payment will take a significant portion of the recovery.¹⁹ Second, fee-shifting could encourage parties with small monetary claims and a high probability of recovery to bring an action. For example, an individual with a near certainty of prevailing on a small or non-monetary claim may still not commence a lawsuit under the American Rule if prosecution were to cost more than the amount at stake. This is particularly true of individuals with limited financial resources facing richer opponents.²⁰ Third, the threat of fee-shifting

16. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 574 (4th ed. 1992); Ronald Braeutigam et al., *An Economic Analysis of Alternative Fee Shifting Systems*, 47 *LAW & CONTEMP. PROBS.* 173 (1984); John C. Hause, *Indemnity, Settlement, and Litigation, or I'll Be Suing You*, 18 *J. LEGAL STUD.* 157 (1989); Avery Katz, *Measuring the Demand for Litigation: Is the English Rule Really Cheaper?*, 3 *J.L. ECON. & ORG.* 143 (1987); Mause, *supra* note 11, at 37; Edward A. Snyder & James W. Hughes, *The English Rule for Allocating Legal Costs: Evidence Confronts Theory*, 6 *J.L. ECON. & ORG.* 345, 370-75 (1990).

17. See Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 *J. LEGAL STUD.* 55, 65 (1982) (noting lower settlement rates under British Rule).

18. See POSNER, *supra* note 16, at 572.

19. Albert A. Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 *CAL. L. REV.* 792 (1966); Michael F. Mayer & Wayne Stix, *The Prevailing Party Should Recover Counsel Fees*, 8 *AKRON L. REV.* 426 (1974); Rowe, *supra* note 13, at 653-59 (breaking this argument into a fairness component and a compensation component); Mark S. Stein, *Is One-Way Fee Shifting Fairer Than Two-Way Fee Shifting?*, 141 *F.R.D.* 351 (1992) (citing the make-whole principle in support of one-way pro-plaintiff fee-shifting); Phyllis A. Monroe, Comment, *Financial Barriers to Litigation: Attorney Fees and the Problem of Legal Access*, 46 *ALB. L. REV.* 148, 165 (1982).

20. See Ehrenzweig, *supra* note 19, at 795-96; Mause, *supra* note 11, at 26, 33, 42; Rowe, *supra* note 13, at 665-66; Shavell, *supra* note 17, at 59-60; Monroe, *supra* note 19, at 159-61.

could deter some frivolous claims and serve to punish those who bring such claims. Potential litigants might think twice before pursuing weak claims if they know the penalty for failure includes payment of the prevailing party's attorneys' fees.²¹ Fourth, fee-shifting could make settlement more likely as litigants would seek to avoid the risk of bearing the other side's attorneys' fees.²²

Intense debate has raged for many years among academics and jurists over the relative merits of the American and the British Rules.²³ Recently, this discussion has become part of public political discourse over the role of litigation in American society. There has been a public reexamination of the effect of the American Rule on litigation in this country and of the possibility of eliminating the American Rule in whole or in part.²⁴ The American Rule has stubbornly resisted calls for change up to this point, however.

21. See Ehrenzweig, *supra* note 19, at 797; Rowe, *supra* note 13, at 662-63, 665-66; Shavell, *supra* note 17, at 59-60; Kenneth Starr, *The Shifting Panorama of Attorney's Fees Awards: The Expansion of Fee Recoveries in Federal Court*, 28 S. TEX. L. REV. 189, 226-27 (1987); Zemans, *supra* note 13, at 193.

22. See John J. Donohue III, *Opting for the British Rule, or If Posner and Shavell Can't Remember the Coase Theorem, Who Will?*, 104 HARV. L. REV. 1093 (1991); see also Bradley L. Smith, *Three Attorney Fee-Shifting Rules and Contingency Fees: Their Impact on Settlement Incentives*, 90 MICH. L. REV. 2154 (1992).

23. For a history of this debate, see Leubsdorf, *supra* note 10. For a general bibliography of the major commentaries on this subject, see Kathryn M. Christie, *Attorney Fee Shifting: A Bibliography*, 47 LAW & CONTEMP. PROBS. 347 (1984). For a review of the extensive law and economics literature on the subject, see Richard D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067 (1989); Keith N. Hylton, *Fee Shifting and Incentives to Comply with the Law*, 46 VAND. L. REV. 1069 (1993).

24. A bill to adopt a form of the British Rule in all federal cases based on diversity jurisdiction has recently been proposed in the U.S. House of Representatives as the Common Sense Legal Reforms Act, HR 10. In the Senate, the proposed Civil Justice Reform Act of 1995, S243, contains a similar provision. Mark Thompson, *Who Wins When the Loser Pays?*, S.F. DAILY J., Feb. 10, 1995, at 1. These proposals are part of the Republican Party's "Contract With America," and are allegedly intended to prevent frivolous lawsuits. David Seidman, *Odds on the Contract*, TIME, Jan. 9, 1995, at 27. The proposals are modeled on a similar effort begun in the Bush Administration under the aegis of the President's Council on Competitiveness, led by Vice President Quayle, which also advocated two-way fee-shifting. See PRESIDENT'S COUNCIL ON COMPETITIVENESS, AGENDA FOR CIVIL JUSTICE REFORM 8-9 (1991). In addition, Governor Wilson is currently sponsoring a bill in the California Assembly to require fee-shifting in cases in which a party refuses a formal settlement offer and then subsequently fails to obtain a more favorable judgment. In proposing this legislation, Governor Wilson stated that it would "curb the plague of lawsuits" which are driving jobs out of the state. CALIFORNIA COMMITTEE ANALYSIS STATEMENT, BILL NO. AB 54, May 10, 1995. See also Kritzer, *supra* note 12, at 56-58.

*B. The Contractual Exception and the Enactment of
Civil Code Section 1717*

The contractual exception to the American Rule is probably the most widely used means of fee-shifting in California. Pursuant to the contractual exception, parties to a contract may agree to opt out of the American Rule in any manner which they desire. Typically, parties will agree to adopt the British Rule so that the loser in any litigation arising under the contract will pay the winner's attorneys' fees. The contractual exception is not limited to this typical case, however. Contracting parties could construct any fee-shifting rule they desired. For example, parties could agree that only the defendant could recover fees if he prevailed in any action on the contract. This would create a steep disincentive for parties to initiate any lawsuits unless they were very confident of success. Another possible variant is a contract provision allowing the prevailing party to recover up to a fixed amount of attorneys' fees or up to a fixed percentage of the contract amount as attorneys' fees, in order to limit the exposure of either party in potential litigation.²⁵

A more nefarious possibility is the contract providing for only one party to the contract, typically the drafter, or the party with greater bargaining power, to recover attorneys' fees. Through such a provision, large corporations and organizations could take advantage of their superior bargaining power vis-à-vis individuals and impose a one-way fee-shifting provision in mass consumer contracts. The contract could require the individual consumer to pay the corporation's attorneys' fees if the corporation prevailed in any suit over the contract, but would not impose a corresponding burden on the corporation if the individual prevailed in any such litigation. This provision would obviously deter litigation by normally risk-averse individuals against corporate defendants. One court described such one-way fee-shifting provisions as "instruments of oppression to force settlements of dubious or unmeritorious claims."²⁶ Such unilateral attorneys' fees provisions

25. *Reynolds Metals Co. v. Alperson*, 25 Cal. 3d 124, 130, 599 P.2d 83, 86, 158 Cal. Rptr. 1, 4 (1979) (approving such a contractual provision).

26. *Coast Bank v. Holmes*, 19 Cal. App. 3d 581, 596-97, 97 Cal. Rptr. 30, 39 (1971).

were found in many contracts in California, including mass consumer contracts such as promissory notes,²⁷ deeds of trust,²⁸ factoring agreements,²⁹ rental agreements,³⁰ construction contracts,³¹ and association by-laws.³² Such fee-shifting provisions were generally enforceable.³³

In response to this problem, in 1968, the Legislature enacted Civil Code section 1717. The central and most heavily litigated provision of section 1717 is the initial paragraph, which provides:

In any action on a contract, where the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party, then the party who is determined to be the party prevailing on the contract, whether he or she is the party specified in the contract or not, shall be entitled to reasonable attorney's fees in addition to other costs.³⁴

This provision requires that all contracts that include fee-shifting clauses be reciprocal. Thus, the prevailing party will recover her fees in every contract action in which the contract provides for fee-shifting.³⁵

27. See, e.g., *Bank of Idaho v. Pine Avenue Assocs.*, 137 Cal. App. 3d 5, 8, 186 Cal. Rptr. 695, 697 (1982); *Associated Convalescent Enters. v. Carl Marks & Co., Inc.*, 33 Cal. App. 3d 116, 118 n.1, 108 Cal. Rptr. 782, 783 n.1 (1973); *Coast Bank*, 19 Cal. App. 3d at 593, 97 Cal. Rptr. at 37; see also 7 B.E. WITKIN, CALIFORNIA PROCEDURE § 134(1) (3d ed. 1985) (citing cases).

28. See, e.g., *Valley Bible Ctr. v. Western Title Ins. Co.*, 138 Cal. App. 3d 931, 932, 188 Cal. Rptr. 335, 336 (1983); *Star Pac. Inv., Inc. v. Oro Hills Ranch, Inc.*, 121 Cal. App. 3d 447, 459, 176 Cal. Rptr. 546, 552 (1981); see also WITKIN, *supra* note 27, § 134(2) (citing cases).

29. See, e.g., *T.E.D. Bearing Co. v. Walter E. Heller Co.*, 38 Cal. App. 3d 59, 62 n.4, 112 Cal. Rptr. 910, 913 n.4 (1974).

30. See, e.g., *Hastings v. Matlock*, 171 Cal. App. 3d 826, 831, 217 Cal. Rptr. 856, 860 (1985); *San Luis Obispo Bay Properties, Inc. v. Pacific Gas & Elec. Co.*, 28 Cal. App. 3d 556, 570, 104 Cal. Rptr. 733, 743 (1972); see also WITKIN, *supra* note 27, § 134(3).

31. See, e.g., *Ecco-Phoenix Elec. Corp. v. Howard J. White, Inc.*, 1 Cal. 3d 266, 272, 461 P.2d 33, 36, 81 Cal. Rptr. 849, 852 (1969); *Sciarrotta v. Teaford Custom Remodeling, Inc.*, 110 Cal. App. 3d 444, 446, 167 Cal. Rptr. 889, 890 (1980); see also WITKIN, *supra* note 27, § 134(4) (citing cases).

32. See, e.g., *Malibu Lake Mountain Club v. Smith*, 18 Cal. App. 3d 31, 35, 95 Cal. Rptr. 553, 556 (1971).

33. In *Malibu*, the court held that such one-way fee-shifting provisions were well established in California law and noted no public policy problems with them. *Id.* But see *Ecco-Phoenix*, 1 Cal. 3d 266, 461 P.2d 38, 81 Cal. Rptr. 849 (narrowly interpreting a one-way fee-shifting provision to avoid an unfair result).

34. CAL. CIV. CODE § 1717(a) (West Supp. 1995).

35. Washington and Oregon have passed similar legislation. See OR. REV. STAT. § 20.096 (1988 & Supp. 1994); WASH. REV. CODE ANN. § 4.84.330 (West 1988). Some states have gone even further. Alaska has statutorily adopted the British Rule for all cases. ALASKA R. CIV. P. § 82(a). See Gregory J. Hughes, Comment, *Award of Attorneys' Fees in Alaska: An Analysis of Rule 82*, 4 UCLA-ALASKA L. REV. 129 (1974); Vargo, *supra* note 6, at 1622-26. In Arizona, the British Rule is the norm in all contract actions. The state statute provides that, in any contested action arising out of

The Legislature enacted section 1717 as a consumer protection law "intended to protect persons of limited means who sign contracts with those in a superior bargaining position."³⁶ The statute had two interrelated goals. The first was to ensure the reciprocity of contract provisions for attorneys' fees and that those provisions did not protect only the party with superior bargaining power.³⁷ If a contract contained a fee-shifting provision, it would henceforth apply to both parties.³⁸ Second, the statute had the related purpose of preventing the oppressive use of one-sided attorneys' fees provisions. Consumers as well as large corporations should be able to vindicate their legal rights through the legal system.³⁹ It was hoped that the reciprocity created by section 1717 would deter corporations from overreaching in their contracts with consumers.⁴⁰

Although section 1717 was designed for those situations in which the parties to the litigation were also parties to the contract, much of the litigation over this section has involved the right of non-parties to

a contract, the court may award reasonable attorneys' fees to the prevailing party, even if the contract does not provide for attorneys' fees. ARIZ. REV. STAT. ANN. § 12-341.01 (1992).

36. Kent S. Scheidegger, Comment, *Attorney's Fees and Civil Code 1717*, 13 PAC. L.J. 233, 236 (1981) (quoting Enrolled Bill Memorandum to Governor Reagan from his legislative secretary, June 5, 1968 (chaptered bill file 68-AB563, California State Archives)). Scheidegger describes this memorandum as "virtually the only available evidence of actual legislative intent." *Id.*

37. One court identified this as the "sole purpose of section 1717." *Associated Convalescent Enters. v. Carl Marks & Co., Inc.*, 33 Cal. App. 3d 116, 120, 108 Cal. Rptr. 782, 784 (1973). *See also* *San Luis Obispo Bay Properties, Inc. v. Pacific Gas & Elec. Co.*, 28 Cal. App. 3d 556, 570, 104 Cal. Rptr. 733, 743 (1972); *System Inv. Corp. v. Union Bank*, 21 Cal. App. 3d 137, 163, 98 Cal. Rptr. 735, 752 (1971); CAL. CONTINUING EDUC. OF THE BAR, REVIEW OF SELECTED 1968 CODE LEGISLATION 35-36 (1968) [hereinafter REVIEW].

38. *System Inv. Corp.*, 21 Cal. App. 3d at 163, 98 Cal. Rptr. at 752.

39. "Civil Code section 1717 is part of an overall legislative policy designed to enable consumers and others who may be in a disadvantageous contractual bargaining position to protect their rights through the judicial process by permitting recovery of attorney's fees incurred in litigation in the event they prevail." *Coast Bank v. Holmes*, 19 Cal. App. 3d 581, 597 n.3, 97 Cal. Rptr. 30, 39 n.3 (1971).

40. Whether this goal was actually attained is debatable. One commentator has noted that, in the wake of the passage of § 1717, parties with superior bargaining power simply manipulate when a right to attorneys' fees is available to either party. The consumer will still never be able to recover her fees. "The only result of the statute is to make mass contractors more careful about when they provide for the recovery of litigation expenses in their standard forms." W. David Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1, 9 (1975).

recover their attorneys' fees or their liability to pay attorneys' fees pursuant to a contractual fee-shifting provision.⁴¹ Since the enactment of section 1717, California courts have gradually extended the ambit of the statute to award attorneys' fees even in the absence of privity of contract between the litigating parties. As one court remarked, "The repercussions of the section . . . set off sympathetic vibrations in situations other than this straightforward one."⁴² This has greatly expanded the range of cases in which the prevailing party can recover attorneys' fees in contract actions.

C. Initial Case Law Applying Section 1717 to Contractual Non-Signatories

Courts have grappled with litigants' attempts to apply section 1717 to contractual non-signatories since shortly after the statute was enacted. The early cases debated whether section 1717 allowed non-signatories to recover attorneys' fees at all.⁴³ The first courts that addressed this issue came to widely divergent results without any consistent rationale. These early cases merit detailed discussion because the factual contexts involved and the various theories raised continue to define the parameters of the debate of the applicability of section 1717 to non-signatories.

I. Arnold v. Browne—Privity

The first appellate decision to discuss this issue was *Arnold v. Browne*,⁴⁴ which held that a non-signatory could not recover attorneys'

41. For a discussion of other issues raised by § 1717, see James D. Acoba, *Recovery of Attorney's Fees in Actions to Enforce Contracts: California Civil Code Section 1717*, 12 W. ST. U. L. REV. 751 (1985), discussing the issues of whether an action is to enforce a contract and who is a prevailing party; see also Cuddy, *supra* note 8, discussing issues of attorneys' fees as part of an appeal bond; Scheidegger, *supra* note 36, discussing the statute generally.

42. *Wilson's Heating & Air Cond. v. Wells Fargo Bank*, 202 Cal. App. 3d 1326, 1332, 249 Cal. Rptr. 553, 557 (1988).

43. See, e.g., *Pas v. Hill*, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978), *overruled* by *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 168 Cal. Rptr. 552 (1980); *Canal-Randolph Anaheim, Inc. v. Wilkoski*, 78 Cal. App. 3d 477, 144 Cal. Rptr. 474 (1978); *Care Constr. Co. v. Century Convalescent Ctrs.*, 54 Cal. App. 3d 701, 126 Cal. Rptr. 761 (1976); *Babcock v. Omansky*, 31 Cal. App. 3d 625, 107 Cal. Rptr. 512 (1973); *Arnold v. Browne*, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775 (1972), *disapproved* by *Reynolds Metals Co. v. Alpers*, 25 Cal. 3d 124, 129, 599 P.2d 83, 86, 158 Cal. Rptr. 1, 3 (1979); *Boliver v. Surety Co.*, 72 Cal. App. 3d Supp. 22, 140 Cal. Rptr. 259 (1977); see also *infra* text accompanying note 62.

44. 27 Cal. App. 3d 386, 103 Cal. Rptr. 775 (1972), *disapproved* by *Reynolds Metals Co. v. Alpers*, 25 Cal. 3d 124, 129, 599 P.2d 83, 86, 158 Cal. Rptr. 1, 3 (1979). For a discussion of *Reynolds*, see the text accompanying note 67, *infra*.

fees under Civil Code section 1717. In *Arnold*, the plaintiffs attempted to recover the amount due on a promissory note from the officers and directors of the corporate signatory of the note, based on an alter ego theory. The individual defendants prevailed and sought to recover their attorneys' fees under section 1717.

The *Arnold* defendants based their argument for fees on ambiguity in the language of the statute. At the time the case was decided, the relevant language from Section 1717 provided as follows:

In any action on a contract, where such contract specifically provides that attorney's fees and costs, which are incurred to enforce the provisions of such contract, shall be awarded to one of the parties, *the prevailing party, whether he is the party specified in the contract or not*, shall be entitled to reasonable attorney's fees in addition to costs and necessary disbursements.⁴⁵

The *Arnold* defendants argued that the phrase "whether he is the party specified in the contract or not" meant that *any* party prevailing in litigation over a contract containing an attorneys' fees clause is entitled to fees, regardless of whether he is a party to the contract or not.

The *Arnold* court rejected this argument because the language immediately preceding this ambiguous phrase specifically refers to "one of the parties" to the contract. The *Arnold* court held that only parties *to the contract* could recover fees under section 1717, and so the individual defendants could not recover their attorneys' fees. This appears to be the proper result based on the language of the statute and the intent of the Legislature in enacting section 1717: to make attorneys' fees provisions reciprocal, not to extend the right to attorneys' fees to non-parties.⁴⁶ The interpretation urged by the defendants in *Arnold* would have effectively overturned the American Rule in all contract actions in which the underlying contract contained an attorneys' fees clause, regardless of privity of contract considerations. The *Arnold* court reasoned that this was not the intent of the Legislature in enacting section 1717.⁴⁷

45. *Arnold*, 27 Cal. App. 3d at 397, 103 Cal. Rptr. at 783-84 (emphasis added). The emphasized language remains essentially unchanged in the current version of the statute.

46. See Mark A. Saxon, *Recovery of Attorneys Fees by the Non-Contracting Defendant*, 55 CAL. ST. B.J. 150, 151 (1980); REVIEW, *supra* note 37, at 35-36.

47. *Arnold*, 27 Cal. App. 3d at 399, 103 Cal. Rptr. at 784.

2. Babcock v. Omansky—Statutory Interpretation

In *Babcock v. Omansky*,⁴⁸ which addressed this issue only nine months later, the court came to the opposite conclusion when faced with nearly identical factual circumstances. *Babcock* also involved an attempt to recover on promissory notes from a non-party. This time, plaintiffs sued the obligor's wife on the theory that she was a joint venturer with her husband. The obligor's wife prevailed and sought attorneys' fees under section 1717. The court allowed the wife, a non-signatory, to recover her fees based on its interpretation of the same statutory language that had been reviewed in *Arnold*. The *Babcock* court held: "As the language of the statute expressly indicates, a party need not be a signatory to the contract in order to recover attorney's fees as the prevailing party—as such prevailing party he becomes entitled to fees 'whether he is the party specified in the contract or not.'"⁴⁹ The *Babcock* court made no mention of *Arnold*, which came to the diametrically opposite conclusion.

3. Care Construction, Inc. v. Century Convalescent Centers, Inc.—Mutuality

In *Care Constr., Inc. v. Century Convalescent Ctrs., Inc.*,⁵⁰ the issue arose a third time. A landlord brought an action for breach of a lease against a putative tenant who denied the existence of the lease. The defendant prevailed when it argued that no binding lease existed between the parties. The court allowed the non-signatory defendant to recover its fees based upon the novel theory of "mutuality." The court reasoned:

Here if [plaintiff] Care had been able to convince the trial court that there was a valid lease between the parties breached by [defendant] Century, then Care would have been able to recover attorney's fees under the lease provision. . . . [W]e think the only way of carrying out the purpose of mutuality found in Civil Code, § 1717, is by holding that Century is entitled to attorney's fees on appeal.⁵¹

Under this theory, if one party to the contract could recover fees by prevailing, then the opposing party should also be entitled to his fees if he should prevail, regardless of whether the parties are in privity of contract.⁵² Although *Care Constr.* cited *Babcock* with approval, the

48. 31 Cal. App. 3d 625, 107 Cal. Rptr. 512 (1973).

49. *Id.* at 633, 107 Cal. Rptr. at 518.

50. 54 Cal. App. 3d 701, 126 Cal. Rptr. 761 (1976).

51. *Id.* at 705, 126 Cal. Rptr. at 763.

52. Mutuality theory is discussed in detail *infra* text accompanying notes 108-44.

Care Constr. court did not look to the language of the statute to reach its conclusion, as did *Babcock*.

4. Canal-Randolph Anaheim, Inc. v. Wilkoski—*Reprise of Privity*

The direct conflict between *Babcock*, *Arnold*, and *Care Constr.* remained unaddressed and unresolved by the appellate courts until 1978,⁵³ when the tension between these cases was finally discussed in *Canal-Randolph Anaheim, Inc. v. Wilkoski*.⁵⁴ In *Canal-Randolph*, plaintiff was a lessor of real property. Defendant was a former employee of the original lessee who started making the lease payments after the original tenancy dissolved. Defendant was neither the successor to, nor a sub-tenant of, the original tenant, so there was no contractual relationship between the parties. Plaintiff brought an unlawful detainer action against the new tenant. The non-signatory defendant prevailed and sought attorneys' fees pursuant to section 1717.

The *Canal-Randolph* court flatly rejected the argument accepted in *Babcock* that the ambiguous language of Section 1717 provided for attorneys' fees awards in favor of prevailing non-parties.⁵⁵ The *Canal-Randolph* court instead agreed with *Arnold* that the meaning of the phrase in section 1717, "whether he is the party specified in the contract or not,"⁵⁶ refers solely to the "party to the contract who prevails."⁵⁷

53. A San Luis Obispo Superior Court, Appellate Department, did address this issue without attempting to resolve it. *Boliver v. Surety Co.*, 72 Cal. App. 3d Supp. 22, 140 Cal. Rptr. 259 (1977). When asked to award attorneys' fees against a surety not in privity of contract with plaintiff on the relevant contract, the *Boliver* court cited both *Babcock* and *Arnold* with approval without attempting to explain the inconsistency between them. The *Boliver* court referred to the decision in *Babcock* as an "extension" of the rule in *Arnold*. *Id.* at 29, 140 Cal. Rptr. at 263. The *Boliver* court limited *Babcock* to its facts of a co-venturer, agent, or partner sued on a contract as if it were a party to the contract. The court held that it would not "further expand the benefits of Civil Code section 1717" beyond the factual situation of *Babcock*. *Id.* at 29, 140 Cal. Rptr. at 264.

54. 78 Cal. App. 3d 477, 144 Cal. Rptr. 474 (1978).

55. The same court, Division Two of the Fourth District Court of Appeals, decided both *Canal-Randolph* and *Care Constr.*. Faced with having approved of *Babcock* in *Care Constr.* in 1976, the *Canal-Randolph* court in 1978 expressly rejected that decision, saying that "our citation of *Babcock v. Omansky* for additional support was both imprecident and unnecessary to the decision. Accordingly, that portion of the opinion in [*Care Constr. Inc.*] citing *Babcock v. Omansky* as additional support is disapproved." *Canal-Randolph*, 78 Cal. App. 3d at 496, 144 Cal. Rptr. at 477 (citations omitted).

56. CAL. CIV. CODE § 1717 (West Supp. 1995).

57. *Canal-Randolph*, 78 Cal. App. 3d at 496, 144 Cal. Rptr. at 476-77.

The *Canal-Randolph* court then looked to the purpose of section 1717 to interpret it. The court reasoned that the statute was designed solely to make attorneys' fees provisions reciprocal for parties to the contract and therefore did not extend that right to non-parties. Like *Arnold*, *Canal-Randolph* held that a non-signatory could not be liable for attorneys' fees under a contract and that privity of contract was a requirement for application of Civil Code section 1717.

5. Pas v. Hill—Estoppel

The broad holding of *Canal-Randolph* did not last very long. The same judicial panel drastically retreated from that decision less than a year later in *Pas v. Hill*.⁵⁸ In *Pas*, the defendant sold real property and received a promissory note secured by a deed of trust from the purchaser. The purchaser sold the property to plaintiff, who did not assume the promissory note or the deed of trust, although she continued to make payments due on the note. When defendant attempted to enforce the note's due-on-sale clause, plaintiff brought suit to enjoin defendant from foreclosing on the deed of trust. Plaintiff prevailed and sought attorneys' fees based on section 1717.

Pas extensively analyzed the issue and held that plaintiff was not entitled to attorneys' fees. The court did not base its decision on the privity arguments used in *Arnold* and *Canal-Randolph*. Instead, the *Pas* court first reiterated its interpretation of section 1717 as set forth in *Canal-Randolph*, that neither the express language nor the legislative intent of the statute could support an award of attorneys' fees to non-signatories. Inexplicably, the *Pas* court then went well beyond the facts before it and reversed its own broad holding in *Canal-Randolph*. In dicta the court stated that "it is not necessary to be a signatory to the contract to recover attorney fees under section 1717."⁵⁹ The *Pas* court agreed with the specific holding of *Babcock* that where a signatory plaintiff attempts to prove a non-signatory defendant's liability on a contract containing an attorneys' fees clause, and the latter prevails, she may recover fees under the contract. The *Pas* court explained it as a matter of estoppel:

[T]he plaintiffs having alleged and attempted to prove the defendant wife was a party to the notes as a joint venturer and that she was liable under the notes' attorney fee provisions and having caused defendant wife to defend against such

58. 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978), *overruled by* Saucedo v. Mercury Sav. & Loan Ass'n, 111 Cal. App. 3d 309, 315, 168 Cal. Rptr. 552, 555-56 (1980). For a discussion of *Saucedo*, see the text accompanying notes 123-29, *infra*.

59. *Id.* at 534, 151 Cal. Rptr. at 107.

liability, were estopped to deny defendant wife was a party to the contract for the remedial purposes of Civil Code section 1717.⁶⁰

According to this theory, the mere allegation in a litigant's pleading of the other party's liability for fees pursuant to a contract estops the former from denying her own liability for fees if she loses.⁶¹ The court concluded that the facts in the case before it did not implicate estoppel principles and so refused to award fees.

In sum, in the first ten years after the Legislature enacted section 1717, five appellate decisions⁶² addressed the question of the ability of non-parties to recover attorneys' fees as prevailing parties under section 1717, and came up with four different holdings: *Arnold* and *Canal-Randolph* held that privity of contract between the parties to the litigation was always required for an award of fees. *Babcock* held that a prevailing party could always recover fees, whether a party to the underlying contract or not. *Care Constr.* held that a non-signatory could sometimes recover fees in accordance with the principle of "mutuality" of section 1717. Finally, *Pas* held that a non-signatory could recover fees in accordance with the principle of estoppel.

D. Reynolds Metals Co. v. Alpers—*The Supreme Court Affirms Fee-Shifting For Contractual Non-Signatories Under Section 1717*

This issue came before the California Supreme Court in 1979 in *Reynolds Metals Co. v. Alpers*.⁶³ In *Reynolds*, plaintiff sought to enforce the terms of a promissory note against non-signatory shareholders and directors of the corporation that had executed the note, on a theory of alter ego liability. The corporation executing the note had filed for bankruptcy and was not a party to the case. The non-signatory defendants prevailed and sought attorneys' fees under section 1717.

The supreme court decided the question of the applicability of section 1717 to non-signatories in extremely summary fashion, without any detailed analysis. First, as the courts in *Arnold*, *Babcock*, and *Canal-*

60. *Id.* at 535-36, 151 Cal. Rptr. at 108 (citations omitted).

61. Estoppel theory is discussed in detail *infra* text accompanying notes 92-107.

62. One judge decided three of these cases: Judge Kaufman of Division Two of the Fourth District Court of Appeals decided *Canal-Randolph*, *Care Constr.*, and *Pas*. For further discussion, see *supra* notes 55 and 58.

63. 25 Cal. 3d 124, 599 P.2d 83, 158 Cal. Rptr. 1 (1979).

Randolph had done, the *Reynolds* court looked to the language of the statute,⁶⁴ which it found ambiguous:

The language of the statute is unclear as to whether it shall be applied to litigants who like defendants have not signed the contract. The section refers to "any action on a contract" thus including any action where it is alleged that a person is liable on a contract, whether or not the court concludes he is a party to that contract. Nevertheless the terms "parties" and "party" are ambiguous. It is unclear whether the Legislature used the terms to refer to signatories or to litigants.⁶⁵

Because the language of the statute was unclear, the court then looked to the statute's legislative intent, which it determined was: (1) to make attorneys' fees clauses reciprocal, and (2) to prevent oppressive use of one-sided attorneys' fees provisions. Based on this legislative intent, the court reasoned:

Its purposes require section 1717 be interpreted to further provide a reciprocal remedy for a nonsignatory defendant, sued on a contract as if he were a party to it, when a plaintiff would clearly be entitled to attorney's fees should he prevail in enforcing the contractual obligation against the defendant.⁶⁶

Reynolds then cited *Babcock, Pas, Canal-Randolph*, and *Boliver* with approval, and disapproved of *Arnold*. The court concluded that the non-signatory defendant could recover fees, reasoning: "Had plaintiff prevailed on its [contract] cause of action . . . , defendants would have been liable on the notes. Since they would have been liable for attorney's fees pursuant to the fees provision had plaintiff prevailed, they may recover attorneys' fees pursuant to section 1717 now that they have prevailed."⁶⁷ *Reynolds* thus established that a contractual non-signatory may, in some cases, recover attorneys' fees as the prevailing party in a contract action pursuant to section 1717.

Reynolds also created a two-part test for determining when a contractual non-signatory may recover fees under section 1717. First, the non-signatory must be "sued on a contract as if he were a party to it."⁶⁸ Second, the signatory party must "clearly be entitled to attorneys' fees should he prevail in enforcing the contractual obligation against the [non-signatory]."⁶⁹ The first part of this test is relatively uncontroversial. Courts have uniformly held that any cause of action or

64. For the text of § 1717 at the time of this decision, see *supra* text accompanying note 34.

65. *Reynolds*, 25 Cal. 3d at 128, 599 P.2d at 85, 158 Cal. Rptr. at 3.

66. *Id.*

67. *Id.* at 129, 599 P.2d at 86, 158 Cal. Rptr. at 3 (citation omitted).

68. *Id.* at 128, 599 P.2d at 85, 158 Cal. Rptr. at 3.

69. *Id.*

defense related to a contract, such as an alter ego claim or a third party beneficiary claim, are actions on a contract.⁷⁰ The second part of this test has created most of the uncertainty for non-signatories seeking fees. It is unclear what it means to be "clearly entitled to fees," or when and how this determination is to be made. Furthermore, the summary manner in which the *Reynolds* court addressed this issue left later courts with few clues as to how to resolve those unanswered questions.

In sum, *Reynolds* left more questions open than it resolved. The court did not establish any clear legal standard for applying Civil Code section 1717 to non-signatories. In addition, because *Reynolds* formally endorsed *Babcock*, *Care Constr.*, and *Pas*, without distinguishing between their differing rationales,⁷¹ later courts were forced to choose between the two possible theoretical bases provided by these earlier decisions to fashion their own rules for applying section 1717.

II. THE APPLICATION OF SECTION 1717 TO CONTRACTUAL NON-SIGNATORIES AFTER *REYNOLDS*: CASES AND THEORIES

Reynolds' failure to elaborate any rationale for its decision spawned intense litigation over the application of section 1717 to factual situations differing from that presented in *Reynolds*. *Reynolds* established only that a prevailing non-signatory defendant can recover attorneys' fees from a losing signatory plaintiff. Since *Reynolds*, litigation about the applica-

70. However, areas of dispute exist as to whether non-contractual causes of action arise out of a contract, thus creating a right to fees under § 1717. See, e.g., *Shadoan v. World Sav. & Loan Ass'n*, 219 Cal. App. 3d 97, 101, 268 Cal. Rptr. 207, 208 (1990) (holding that an action alleging unfair business practices under Business & Professions Code § 17200 that arises out of a contract is an action "on the contract," while an action for fraudulent inducement to enter into a contract is not an action "on the contract"); *Star Pac. Inv., Inc. v. Oro Hills Ranch, Inc.*, 121 Cal. App. 3d 447, 460, 176 Cal. Rptr. 546, 553 (1981) (for purposes of § 1717, an action for rescission is "on a contract"); *Schlocker v. Schlocker*, 62 Cal. App. 3d 921, 133 Cal. Rptr. 485 (1976) (same scenario as *Shadoan*); see also *Glynn v. Marquette*, 152 Cal. App. 3d 277, 199 Cal. Rptr. 306 (1984) (cause of action for specific performance of contract against non-signatory pursuant to CAL. CIV. CODE § 3395 does not create right to fees under § 1717); cf. *Lerner v. Ward*, 13 Cal. App. 4th 155, 16 Cal. Rptr. 2d 486 (1993) (contractual attorneys' fees are available in actions for fraudulent inducement to enter contract pursuant to CAL. CIV. PROC. CODE § 1021). See generally *Acoba*, *supra* note 41, at 754-56.

71. One appellate court noted this inconsistency and remarked that the holdings of *Canal-Randolph* and *Babcock* "appear irreconcilable." *Manier v. Anaheim Business Ctr. Co.*, 161 Cal. App. 3d 503, 507 n.4, 207 Cal. Rptr. 508, 511 n.4 (1984).

tion of Civil Code section 1717 has expanded to include every possible combination of prevailing parties and signatories to a contract: a prevailing signatory defendant's ability to recover fees from a losing non-signatory plaintiff,⁷² a prevailing signatory plaintiff's ability to recover fees from a losing non-signatory defendant,⁷³ and a prevailing non-signatory plaintiff's ability to recover fees from a losing signatory defendant.⁷⁴

Although many courts have categorized and examined these cases according to the plaintiff/defendant and party/non-party distinctions outlined above,⁷⁵ this approach is of very limited utility. These categories are so manipulable that no consistent results can be predicted based on them.⁷⁶ Furthermore, courts have granted and disapproved of fees in all of the possible combinations.⁷⁷ A more incisive approach to this issue analyzes the types of cases involving contractual non-

72. See, e.g., *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 30 Cal. Rptr. 2d 536 (1994) (fees awarded); *Brusso v. Running Springs Country Club, Inc.*, 228 Cal. App. 3d 92, 108-11, 278 Cal. Rptr. 758, 766-68 (1991) (fees awarded); *Leach v. Home Sav. & Loan Ass'n*, 185 Cal. App. 3d 1295, 1304-07, 230 Cal. Rptr. 553, 559-61 (1986) (fees not awarded); *Manier*, 161 Cal. App. 3d at 508, 207 Cal. Rptr. at 511-12 (fees awarded); *Jones v. Drain*, 149 Cal. App. 3d 484, 196 Cal. Rptr. 827 (1983) (fees awarded).

73. See, e.g., *Wilson's Heating & Air Cond. v. Wells Fargo Bank*, 202 Cal. App. 3d 1326, 249 Cal. Rptr. 553 (1988) (fees not awarded); *Glynn v. Marquette*, 152 Cal. App. 3d 277, 199 Cal. Rptr. 306 (1984) (fees not awarded). But see *Lewis v. Alpha Beta Co.*, 141 Cal. App. 3d 29, 33, 189 Cal. Rptr. 840, 842 (1983) (fees awarded).

74. See, e.g., *Pilcher v. Wheeler*, 2 Cal. App. 4th 352, 3 Cal. Rptr. 2d 533 (1992) (fees not awarded). But see *Steve Schmidt & Co. v. Berry*, 183 Cal. App. 3d 1299, 228 Cal. Rptr. 689 (1986) (fees awarded); *Wilhite v. Callihan*, 135 Cal. App. 3d 295, 301-02, 185 Cal. Rptr. 215, 218-19 (1982) (fees awarded); *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 168 Cal. Rptr. 552 (1980) (fees awarded); *In re Vista Medical Investors, Ltd.*, 98 B.R. 29 (Bankr. S.D. Cal. 1989) (fees awarded).

75. See, e.g., *Real Property Servs.*, 25 Cal. App. 4th at 380-82, 30 Cal. Rptr. 2d at 539-41; *Wilson's Heating*, 202 Cal. App. 3d at 1333 nn.6-7, 249 Cal. Rptr. at 557 n.6, 558 n.7; *Leach*, 185 Cal. App. 3d at 1306, 230 Cal. Rptr. at 560-61.

76. For example, a party who is a defendant in one case could be a plaintiff in another case involving the same fact pattern merely by initiating the action and seeking declaratory or injunctive relief. See *Star Pac. Inv., Inc. v. Oro Hills Ranch*, 121 Cal. App. 3d 447, 460, 176 Cal. Rptr. 546, 553 (1981) (noting that the nominal "plaintiff" may in some cases file suit as a "defensive response" to the nominal defendant's extra-judicial actions). Compare *Pas v. Hill*, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978) (plaintiff was a non-assuming grantee under a deed of trust that sought declaratory relief and an injunction to prevent defendant, the lender under the deed of trust, from enforcing a due-on-sale clause), overruled by *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 315, 168 Cal. Rptr. 552, 555-56 (1980), with *Santa Clara Sav. & Loan Ass'n v. Pereira*, 164 Cal. App. 3d 1089, 211 Cal. Rptr. 54 (1985) (plaintiff was the lender under the deed of trust who brought an action against the original trustor and the non-assuming grantee of the subject property, seeking to enforce the due-on-sale clause of the underlying note).

77. See cases cited *supra* notes 72-74.

signatories in which courts have shifted attorneys' fees and the theories used to justify such fee-shifting.

A. Current Application of Section 1717 to Contractual Non-Signatories

Litigants in contract actions who are not signatories to the contract in dispute have received or been liable for attorneys' fees pursuant to section 1717 in four broad types of cases. In the first situation, a signatory to a contract with an attorneys' fees clause sues a non-signatory alleging the non-signatory's liability under an alter ego, conspiracy, co-venturer, or similar theory. If the non-signatory defendant prevails, the court may award her fees under section 1717. The courts analyzed this factual situation in *Reynolds*,⁷⁸ *Arnold*,⁷⁹ and *Babcock*,⁸⁰ and in several other reported cases.⁸¹

In the second common situation, a party asserts the existence of a contract later found unenforceable. If the alleged contract contained an attorneys' fees clause, courts have granted fees pursuant to section 1717 to the party denying enforceability. The *Manier v. Anaheim Business Ctr. Co.*⁸² court allowed fee-shifting under section 1717 when the contract was found unenforceable because plaintiffs had added additional terms that were never accepted by defendants. The non-signatory defendants recovered their attorneys' fees despite the lack of an enforceable contract between the parties. This closely paralleled the factual situation found in *Care Constr.*⁸³ and several other cases.⁸⁴

78. *Reynolds Metals Co. v. Alperson*, 25 Cal. 3d 124, 599 P.2d 83, 158 Cal. Rptr. 1 (1979).

79. *Arnold v. Browne*, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775 (1972), disapproved by *Reynolds Metals Co. v. Alperson*, 25 Cal. 3d 124, 129, 599 P.2d 83, 86, 158 Cal. Rptr. 1, 3 (1979).

80. *Babcock v. Omansky*, 31 Cal. App. 3d 625, 107 Cal. Rptr. 512 (1973).

81. See, e.g., *Walsh v. New W. Fed. Sav. & Loan*, 234 Cal. App. 3d 1539, 1542, 1 Cal. Rptr. 2d 35, 37 (1991); *Southern Cal. Pipe Trades Dist. Council No. 16 v. Merritt*, 126 Cal. App. 3d 530, 541, 179 Cal. Rptr. 794, 801 (1981).

82. 161 Cal. App. 3d 503, 207 Cal. Rptr. 508 (1981).

83. *Care Constr., Inc. v. Century Convalescent Ctrs., Inc.*, 54 Cal. App. 3d 701, 126 Cal. Rptr. 761 (1976), discussed *supra* text accompanying notes 50-52.

84. See, e.g., *Hsu v. Abbara*, 9 Cal. 4th 863, 866-68, 891 P.2d 804, 806-07, 39 Cal. Rptr. 2d 824, 826-27 (1995); *Balistreri v. Nevada Livestock Prod. Credit Ass'n*, 214 Cal. App. 3d 635, 644, 262 Cal. Rptr. 862, 866-67 (1989); *North Assocs. v. Bell*, 184 Cal. App. 3d 860, 865, 229 Cal. Rptr. 305, 308-09 (1986); *Manier v. Anaheim Business Ctr. Co.*, 161 Cal. App. 3d 503, 508, 207 Cal. Rptr. 508, 511-12 (1984).

In the third type of case in which litigants commonly invoke section 1717 to award fees vis-a-vis non-signatories, a non-signatory third party beneficiary to a contract containing an attorneys' fees clause sues a signatory on the contract. Typically, a sub-tenant sues the master landlord on the master lease,⁸⁵ or a real estate agent sues the parties to a real property purchase and sale agreement whom the agent served as broker.⁸⁶ In both of these examples, the plaintiff is a known third party beneficiary of the contract suing to enforce his rights under the contract.

The fourth general category involves a non-assuming grantee of real property encumbered by a pre-existing deed of trust.⁸⁷ The non-assuming grantee and the trustee are not in privity of contract because the non-assuming grantee is not a party to the deed of trust or the promissory note.⁸⁸ Some courts have held that if the trustee seeks to judicially enforce the deed of trust, or the non-assuming grantee sues to enjoin the trustee from doing so, the prevailing party may recover fees under section 1717. *Pas* was the first case to discuss this scenario. While *Pas* refused to award fees, many cases since then have granted fees in this situation.⁸⁹

In addition to these four categories, fees have been awarded in other situations based on the equities of the individual case. For example, one court made an equitable fee-shifting rule reciprocal on the basis of section 1717 when a contract was involved in the underlying dispute.⁹⁰ In this case, no contract was even in dispute between the parties to the

85. See, e.g., *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 382-84, 30 Cal. Rptr. 536, 540-42 (1994) (subtenant was the losing third party beneficiary/plaintiff who was held liable for fees); cf. *In re Vista Medical Investors, Ltd.*, 98 B.R. 29, 34 (Bankr. S.D. Cal. 1989) (subtenant was prevailing third party beneficiary/plaintiff who recovered fees).

86. See, e.g., *Steve Schmidt & Co. v. Berry*, 183 Cal. App. 3d 1299, 228 Cal. Rptr. 689 (1986) (prevailing third party beneficiary/plaintiff recovers fees); cf. *Jones v. Drain*, 149 Cal. App. 3d 484, 487-88, 196 Cal. Rptr. 827, 829-30 (1983) (losing third party beneficiary/plaintiff held liable for fees).

87. A "non-assuming grantee" is a party who acquires real property encumbered by a pre-existing senior lien, but does not contractually assume the obligations of that senior encumbrance. See generally ROGER BERNHARDT, CALIFORNIA MORTGAGE AND DEED OF TRUST PRACTICE § 8.21 (2d ed. 1990).

88. See *Braun v. Crew*, 183 Cal. 728, 192 P. 531 (1920).

89. See, e.g., *Santa Clara Sav. & Loan Ass'n v. Pereira*, 164 Cal. App. 3d 1089, 1098, 211 Cal. Rptr. 54, 59 (1985) (non-assuming grantee held liable for fees); cf. *Wilhite v. Callihan*, 135 Cal. App. 3d 295, 301-02, 185 Cal. Rptr. 215, 219 (1982) (non-assuming grantee recovered fees); *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 315, 168 Cal. Rptr. 552, 555-56 (1980) (same). But see *Smith v. Kreuger*, 150 Cal. App. 3d 752, 757, 198 Cal. Rptr. 174, 176 (1983) (applying same principle to allow original trustors under deed of trust to recover fees); *Valley Bible Ctr. v. Western Title Ins. Co.*, 138 Cal. App. 3d 932, 933, 188 Cal. Rptr. 335, 336 (1983) (same).

90. See *Brusso v. Running Springs Country Club, Inc.*, 228 Cal. App. 3d 92, 278 Cal. Rptr. 758 (1991).

action. In a second example not fitting into any category, the signatories to a lease sued the adjoining lessee, a signatory to a similar lease with the same landlord.⁹¹ There was no privity of contract between plaintiffs and defendant, but the former were suing to enforce a non-compete clause in their own lease that benefitted the latter. Defendant was thus a non-signatory third party beneficiary of the contract. Plaintiffs prevailed and recovered their attorneys' fees from defendant pursuant to an attorneys' fees clause in both leases.

B. Theoretical Justifications

Courts have used two theories to justify fee-shifting under section 1717 in cases involving contractual non-signatories: estoppel theory and mutuality theory. While these theories will often produce the same result, important differences generate differing outcomes under certain circumstances.

1. Estoppel Theory

Estoppel theory applies general estoppel principles to section 1717. Under the general rule of estoppel, a party may not deny a fact he has represented to the other side as true when that representation would yield an unfair or unjust result.⁹² This principle applies to section 1717 when a party, claiming a right to attorneys' fees pursuant to a contractual provision, is estopped from denying the other party's right to recover attorneys' fees if the other party prevails.⁹³ As one court proverbially put it, "Under Civil Code Section 1717, what is sauce for the goose is sauce for the gander"⁹⁴

Courts have used two arguments to justify applying estoppel principles to section 1717. First, they have relied on the equitable purposes of the statute. Section 1717 was intended to remedy unfair and unequal

91. *Lewis v. Alpha Beta Co.*, 141 Cal. App. 3d 29, 189 Cal. Rptr. 840 (1983).

92. See 11 B.E. WITKIN, SUMMARY OF CALIFORNIA LAW § 176 (9th ed. 1990). See also CAL. CIV. CODE § 1589 (West 1982); CAL CIV. CODE § 3521 (West 1970 & Supp. 1995); CAL. EVID. CODE § 623 (West 1966).

93. See *Manier v. Anaheim Business Ctr. Co.*, 161 Cal. App. 3d 503, 508, 207 Cal. Rptr. 508, 511 (1984); *Jones v. Drain*, 149 Cal. App. 3d 484, 490, 196 Cal. Rptr. 827, 831 (1983).

94. *Valley Bible Ctr. v. Western Title Ins. Co.*, 138 Cal. App. 3d 932, 933, 188 Cal. Rptr. 335, 336 (1983).

attorneys' fees provisions by making them reciprocal.⁹⁵ Courts have reasoned that this goal of reciprocity should be broadly extended to parties not in privity of contract on the basis of equity.⁹⁶ Courts addressing other aspects of Section 1717 have consistently held that equitable principles govern the statute.⁹⁷ Indeed, California courts have generally construed contractual attorneys' fees clauses liberally.⁹⁸

Second, the language of *Reynolds* supports estoppel theory. *Reynolds's* approval of *Pas*, which first articulated the application of estoppel principles to section 1717, certainly lends credibility to the theory. In addition, *Reynolds's* failure to explain the theoretical basis for its decision created a doctrinal vacuum for later courts to fill. The *Reynolds* court held only that, when a signatory party is "clearly entitled" to recover fees if she should prevail, then a non-signatory is also entitled to recover her fees. *Reynolds* left an important question unanswered: What does it mean to be "clearly entitled" to attorneys' fees? Courts espousing estoppel theory answered this question in the most inclusive way possible: a party becomes "clearly entitled" to fees by simply alleging an entitlement to them. Under estoppel theory, the determination of the "clarity of entitlement" to attorneys' fees is based on the parties' allegations and not on the facts that are ultimately proven at trial.⁹⁹ The allegation need not even be made in the pleadings, as long as the claim to attorneys' fees is asserted during trial.¹⁰⁰

Under estoppel theory, the fact that a party's allegation of entitlement is baseless or unfounded is irrelevant. Plaintiff does not need a realistic possibility of prevailing on a contract claim for a prevailing non-signatory defendant to recover attorneys' fees.¹⁰¹ One court awarded attorneys' fees to the prevailing defendant "even though the [plaintiff] possessed no evidence to support its cause of action" and plaintiff's

95. See *supra* note 37.

96. See *North Assocs. v. Bell*, 184 Cal. App. 3d 860, 865, 229 Cal. Rptr. 305, 308-09 (1986); *Jones*, 149 Cal. App. 3d at 489, 196 Cal. Rptr. at 831.

97. See, e.g., *International Indus., Inc. v. Olen*, 21 Cal. 3d 218, 223-224, 577 P.2d 1031, 1034, 145 Cal. Rptr. 691, 693-94 (1978); *Bank of Idaho v. Pine Ave. Assocs.*, 137 Cal. App. 3d 5, 16-17, 186 Cal. Rptr. 695, 703 (1982).

98. See, e.g., *Ecco-Phoenix Elec. Corp. v. Howard J. White, Inc.*, 1 Cal. 3d 266, 272, 461 P.2d 33, 36, 81 Cal. Rptr. 849, 852 (1969).

99. See *Manier v. Anaheim Business Ctr. Co.*, 161 Cal. App. 3d 503, 508, 207 Cal. Rptr. 508, 511 (1984); *Jones*, 149 Cal. App. 3d at 487, 196 Cal. Rptr. at 829.

100. See *Walsh v. New W. Fed. Sav. & Loan Ass'n*, 234 Cal. App. 3d 1539, 1547, 1 Cal. Rptr. 2d 35, 40 (1991); *Montgomery v. Bio-Med Specialties, Inc.*, 183 Cal. App. 3d 1292, 1296, 228 Cal. Rptr. 709, 711 (1986).

101. *North Assocs. v. Bell*, 184 Cal. App. 3d 860, 865, 229 Cal. Rptr. 305, 308-09 (1986); *Jones*, 149 Cal. App. 3d at 488-89, 196 Cal. Rptr. at 830-31.

claim "was so devoid of merit that there was no possibility that it ever could have prevailed."¹⁰² Another court held:

As long as an action "involves" a contract, and one of the parties would be entitled to recover attorney fees under the contract if that party prevails in its lawsuit, the other party should also be entitled to attorney fees if it prevails, even if it does so by successfully arguing the inapplicability, invalidity, unenforceability, or nonexistence of the same contract.¹⁰³

Courts have relied on estoppel theory to allow a prevailing non-signatory to recover attorneys' fees in a variety of cases, including claims by a non-signatory third party beneficiary,¹⁰⁴ claims based on unenforceable contracts,¹⁰⁵ and claims against a contractual non-signatory who allegedly is an obligor on the contract.¹⁰⁶ Estoppel theory has not served as a basis to award fees in cases involving non-assuming grantees.¹⁰⁷

2. Mutuality Theory

Mutuality is the other theory courts have used to support awards of attorneys' fees to non-signatories under section 1717. Mutuality differs from estoppel in that the prevailing party is entitled to fees only if the losing party would *actually* have been entitled to recover fees had the losing party prevailed. The mere allegation of an entitlement to fees is not sufficient.

The *Reynolds* holding provides the main support for mutuality theory.¹⁰⁸ This reliance is odd considering that *Reynolds* did not even cite *Care Constr.*, the case originating mutuality theory, but did

102. *Jones*, 149 Cal. App. 3d at 488-89, 196 Cal. Rptr. at 830-31.

103. *North Assocs.*, 184 Cal. App. 3d at 865, 229 Cal. Rptr. at 308.

104. *See, e.g., Steve Schmidt & Co. v. Berry*, 183 Cal. App. 3d 1299, 1314-17, 228 Cal. Rptr. 689, 698-700 (1986); *Jones*, 149 Cal. App. 3d 484, 196 Cal. Rptr. 827.

105. *See, e.g., North Assocs.*, 184 Cal. App. 3d 860, 229 Cal. Rptr. 305; *Manier v. Anaheim Business Ctr. Co.*, 161 Cal. App. 3d 503, 207 Cal. Rptr. 508 (1984).

106. *See, e.g., Walsh v. New W. Fed. Sav. & Loan Ass'n*, 234 Cal. App. 3d 1539, 1 Cal. Rptr. 2d 35 (1991).

107. *Pas* applied estoppel theory to the non-assuming grantee situation and declined to award fees. *Pas v. Hill*, 87 Cal. App. 3d 521, 151 Cal. Rptr. 98 (1978), *overruled by Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 315, 168 Cal. Rptr. 552, 555-56 (1980). *See supra* text accompanying notes 58-61.

108. *See, e.g., Hsu v. Abbata*, 9 Cal. 4th 863, 870, 891 P.2d 804, 809, 39 Cal. Rptr. 2d 824, 829 (1995) (California Supreme Court stated in dicta that *Reynolds* supported mutuality theory).

specifically approve of *Pas*, which originated estoppel theory.¹⁰⁹ Mutuality theory is based on the same language in *Reynolds* as estoppel theory. The key phrase in *Reynolds* is the requirement that the losing party “would clearly be entitled to attorneys’ fees should he prevail in enforcing the contractual obligation” against the prevailing party.¹¹⁰ When using mutuality theory, subsequent courts interpreted this phrase to mean that “the party claiming a right to receive fees [must] establish that the opposing party *actually* would have been entitled to receive them if he or she had been the prevailing party.”¹¹¹ But *Reynolds* contains no such language or holding to this effect.¹¹² *Reynolds* does not require an actual entitlement to recover fees on the part of the losing party. In fact, mutuality theory simply relies on a different determination than estoppel theory as to what stage of the litigation to use to determine when the entitlement to fees becomes clear.¹¹³ Under mutuality theory, courts opt for the proof stage;¹¹⁴ under estoppel theory, courts choose the pleadings stage.¹¹⁵

In order to determine if the prevailing party is entitled to recover attorneys’ fees using mutuality theory, courts must first determine whether the *losing* party could have successfully established a right to recover attorneys’ fees under the facts of the case as proven. This may require a detailed analysis of the losing party’s case, including the party’s legal theories and factual claims. Only if the losing party could actually have recovered attorneys’ fees will the court grant attorneys’ fees to the prevailing party. Mutuality theory thus requires a counter-factual or “backward” analysis.¹¹⁶

109. Many courts espousing mutuality theory have criticized estoppel theory as a misreading of *Reynolds*. See *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 382 n.5, 30 Cal. Rptr. 536, 540 n.5 (1994); *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 548-49, 20 Cal. Rptr. 2d 193, 197 (1993); *Wilson’s Heating & Air Cond. v. Wells Fargo Bank*, 202 Cal. App. 3d 1326, 1333 n.7, 249 Cal. Rptr. 553, 557 n.7 (1988); *Leach v. Home Sav. & Loan Ass’n*, 185 Cal. App. 3d 1295, 1306-07, 230 Cal. Rptr. 553, 560-61 (1986).

110. *Reynolds Metals Co. v. Alperson*, 25 Cal. 3d 124, 128, 599 P.2d 83, 85, 158 Cal. Rptr. 1, 3 (1979).

111. *Real Property Servs.*, 25 Cal. App. 4th at 382, 30 Cal. Rptr. at 540; *Super 7*, 16 Cal. App. 4th at 549, 20 Cal. Rptr. 2d at 540; *Leach*, 185 Cal. App. 3d at 1307, 230 Cal. Rptr. at 561.

112. *Reynolds*, 25 Cal. 3d at 128, 599 P.2d at 85, 158 Cal. Rptr. at 3.

113. *Jones v. Drain*, 149 Cal. App. 3d 484, 487, 196 Cal. Rptr. 827, 829 (1983).

114. See, e.g., *Leach*, 185 Cal. App. 3d at 1307, 230 Cal. Rptr. at 561.

115. See, e.g., *Manier v. Anaheim Business Ctr. Co.*, 161 Cal. App. 3d 503, 508, 207 Cal. Rptr. 508, 511 (1984).

116. Although not termed counter-factual by the court, the process is discussed in *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 382-83, 30 Cal. Rptr. 2d 536, 540-41 (1994); see also *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 549-50, 20 Cal. Rptr. 2d 193, 199-200 (1993); *Artesia Medical Dev. Co. v.*

Courts following mutuality theory often apply the test very broadly, in order to award fees equitably. Courts have gone to extraordinary lengths to find that the losing party had a possibility of recovering attorneys' fees if it had prevailed, so that the prevailing party can recover its attorneys' fees.¹¹⁷ Mutuality theory would provide for fees in each of the four factual situations described above: the alter ego claim, the unenforceable contract claim, the third party beneficiary claim, and the non-assuming grantee situation.¹¹⁸

Mutuality theory would allow fee-shifting under the first type of case, where a signatory alleges that a non-signatory is liable on a contract under an alter-ego or similar type theory. If the losing party had prevailed, it would have recovered its attorneys' fees. Therefore, the prevailing party can recover attorneys' fees.¹¹⁹

Mutuality theory also allows fee-shifting in the second type of case, where a contractual non-signatory defendant prevails on the contract claim by showing that the alleged contract is unenforceable.¹²⁰ Mutuality only requires the mere possibility that the losing party could prevail and recover attorneys' fees under a contractual provision. Only if the losing party could not recover fees under any circumstances will the court deny fees to the prevailing party under mutuality theory.¹²¹

Regency Assocs., Ltd., 214 Cal. App. 3d 957, 962-64, 266 Cal. Rptr. 657, 659-60 (1989); Alhambra Redev. Agency v. Transamerica Fin. Servs., 212 Cal. App. 3d 1370, 1381, 261 Cal. Rptr. 248, 253-54 (1989).

117. See, e.g., Saucedo v. Mercury Sav. & Loan Ass'n, 111 Cal. App. 3d 309, 168 Cal. Rptr. 552 (1980), discussed *infra* at text accompanying notes 123-29; see also Brusso v. Running Springs Country Club, Inc., 228 Cal. App. 3d 92, 278 Cal. Rptr. 758 (1991), discussed *infra* at text accompanying notes 131-35; cases cited *infra* at notes 138-43 and accompanying text.

118. See *supra* text accompanying notes 78-89.

119. See, e.g., Southern Cal. Pipe Trades Dist. Council No. 16 v. Merritt, 126 Cal. App. 3d 530, 541, 179 Cal. Rptr. 794, 801 (1981).

120. Indeed, the seminal mutuality theory case involved a non-signatory party who prevailed by proving that no enforceable agreement existed between the parties. Care Constr., Inc. v. Century Convalescent Ctrs., Inc., 54 Cal. App. 3d 701, 707, 126 Cal. Rptr. 761, 765 (1976) (discussed *supra* text accompanying notes 50-52); see also Hsu v. Abbara, 9 Cal. 4th 863, 891 P.2d 804, 39 Cal. Rptr. 2d 824 (1995); Balistreri v. Nevada Livestock Prod. Credit Ass'n, 214 Cal. App. 3d 635, 644, 262 Cal. Rptr. 862, 866-67 (1989); Berge v. International Harvester Co., 142 Cal. App. 3d 152, 164, 190 Cal. Rptr. 815, 823-24 (1983).

121. See Artesia Medical Dev. Co. v. Regency Assocs., Ltd., 214 Cal. App. 3d 957, 962-64, 266 Cal. Rptr. 657, 659-60 (1989); Alhambra Redev. Agency v. Transamerica Fin. Servs., 212 Cal. App. 3d 1370, 1381, 261 Cal. Rptr. 248, 253-54 (1989).

Mutuality theory also provides for fee-shifting in some cases involving third party beneficiaries suing to enforce their rights under a contract. The third party beneficiary's right to recover fees depends upon the court's interpretation of liability for such fees if he had lost. Authority is split on this question.¹²²

The non-assuming grantee situation demonstrates the broad application of mutuality theory in awarding fees to a non-signatory. The first court to apply mutuality theory to this factual scenario was *Saucedo v. Mercury Sav. & Loan Ass'n*.¹²³ The *Saucedo* court first looked at the losing party's right to recover its fees if it had prevailed. Under existing case law, a prevailing trustee cannot recover its fees based on the attorneys' fees clause of the deed of trust because the non-assuming grantees were not parties to the contract.¹²⁴ Thus, the non-assuming grantees should not recover their fees under mutuality principle because the non-assuming grantees could not be liable to the trustee for its fees if the trustee had prevailed.¹²⁵ On further analysis, however, the *Saucedo* court found that, "as a practical matter," the trustee could have recovered its fees if the trustee had prevailed and gone forward with the foreclosure.¹²⁶ The only way for the purchasers to retain their equity in the property would be to pay off the secured debt.¹²⁷ This would include the trustee's attorneys' fees which would be added to the principal amount of the debt pursuant to the deed of trust.¹²⁸

One commentator explained: "[A]s a practical matter, on foreclosure the beneficiary is entitled to recover her fees as a condition to redemp-

122. *Compare In re Vista Medical Investors, Ltd.*, 98 B.R. 29, 34 (Bankr. S.D. Cal. 1989) (third party beneficiary can recover attorneys' fees); *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 383-84, 30 Cal. Rptr. 2d 536, 541-42 (1994) (same) with *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 546, 20 Cal. Rptr. 2d 193, 197 (1993) (third party beneficiary cannot recover attorneys' fees). For a discussion of this conflict, see *infra* text accompanying notes 200-11.

123. 111 Cal. App. 3d 309, 168 Cal. Rptr. 552 (1980). Judge Kaufman, who decided *Pas* as well as *Care Constr. and Canal-Randolph*, also wrote the *Saucedo* opinion. See also *Smith v. Kreuger*, 150 Cal. App. 3d 752, 757, 198 Cal. Rptr. 174, 176 (1983) (addressing the related situation of an award of attorneys' fees in a suit by the original trustor of the deed of trust suing to enjoin the trustee from enforcing the due-on-sale clause); *Wilhite v. Callihan*, 135 Cal. App. 3d 295, 301-02, 185 Cal. Rptr. 215, 219 (1982) (non-assuming grantee recovered fees, following *Saucedo*).

124. *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 596-97, 542 P.2d 981, 985-86, 125 Cal. Rptr. 557, 561-62 (1975) (holding that a non-assuming grantee is not personally liable for obligations created by the pre-existing note and deed of trust).

125. As set forth *supra* in text accompanying notes 111-16, under mutuality, courts will only award fees to the prevailing party if the losing party had a possibility of recovering her fees if she had prevailed.

126. *Saucedo*, 111 Cal. App. 3d at 314, 168 Cal. Rptr. at 555.

127. *Id.*

128. *Id.* at 315, 168 Cal. Rptr. at 555-56.

tion and if the non-assuming grantee wishes to protect his equity in the property he will have to pay those fees."¹²⁹ The non-assuming grantee's potential practical liability for attorneys' fees is great enough to create a reciprocal right to recover attorneys' fees. "[I]n every case in which the non-assuming grantee has a sufficient interest in the property to warrant his resisting foreclosure," the non-assuming grantee can recover attorneys' fees in an action against the trustee of the pre-existing deed of trust.¹³⁰

Courts have also extended *Saucedo's* "realistic" approach to other situations where parties were not in privity of contract. In *Brusso v. Running Springs Country Club, Inc.*,¹³¹ the court reasoned that, where plaintiffs had a right to recover their fees as the prevailing parties under the substantial benefit doctrine, section 1717 creates a reciprocal right to fees for defendants when they prevail.¹³² The substantial benefit doctrine is an equitable exception to the American Rule providing for fee-shifting in favor of the plaintiff in certain cases, usually class action or shareholder derivative suits.¹³³ Under the rule, prevailing plaintiffs may recover their fees when they obtain a judgment resulting in a "substantial benefit" to the defendants.¹³⁴ The *Brusso* court reasoned that if plaintiffs could have recovered their fees pursuant to the substantial benefit doctrine, it would be unjust to deny defendants the right to recover their fees.¹³⁵

Mutuality theory thus potentially extends the scope of section 1717 to non-contractual exceptions to the American Rule. If section 1717 applies to the substantial benefit doctrine, there is no reason why it would not apply to the other equitable exceptions to the American Rule

129. 1 HARRY D. MILLER & MARVIN B. STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE § 3:109 n.16 (rev. ed. 1975 & Supp. 1979), quoted in *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 314, 168 Cal. Rptr. 552, 555 (1980).

130. *Saucedo*, 111 Cal. App. 3d at 315, 168 Cal. Rptr. at 555.

131. 228 Cal. App. 3d 92, 278 Cal. Rptr. 758 (1991).

132. *Id.* at 111, 278 Cal. Rptr. at 769.

133. *Id.* at 99, 278 Cal. Rptr. at 761.

134. See *Woodland Hills Residents Ass'n v. City Council*, 23 Cal. 3d 917, 943, 593 P.2d 200, 214, 154 Cal. Rptr. 503, 517 (1979); *Serrano v. Priest*, 20 Cal. 3d 25, 38-40, 569 P.2d 1303, 1309-11, 141 Cal. Rptr. 315, 320-22 (1977); see also John P. Dawson, *Lawyers and Involuntary Clients: Attorney Fees from Funds*, 87 HARV. L. REV. 1597, 1609-11 (1974) (discussing lawyers' recovery of fees from common funds); PEARL, *supra*, note 7 §§ 7-8 to 7-12.

135. *Brusso*, 228 Cal. App. 3d at 111, 278 Cal. Rptr. at 769.

in California: the common fund doctrine¹³⁶ and the equitable private attorney general doctrine.¹³⁷ There have also been attempts to extend section 1717 to statutory exceptions to the American Rule. In *Covenant Mut. Ins. Co. v. Young*,¹³⁸ the court reversed a trial court's determination that section 1717 would make the attorneys' fees provision found in Civil Code section 3318 reciprocal.¹³⁹ Section 3318 provides one-way fee-shifting in favor of plaintiffs in actions for breach of warranty of authority.¹⁴⁰ The *Covenant* court refused to extend section 1717 into this statutory context.¹⁴¹ Another court applied section 1717 to the one-way fee-shifting provision of Civil Code section 3083, which provides an award of attorneys' fees to the plaintiff in bonded stop-notice actions.¹⁴² Yet another court extended section 1717 to Corporations Code section 800, which provides that in a shareholder derivative suit the court may require plaintiffs to post a bond to cover the opposing side's attorneys' fees.¹⁴³ Mutuality theory could potentially allow application of section 1717 to the hundreds of fee-shifting provisions in

136. Under the common fund doctrine, a prevailing plaintiff can recover attorneys' fees if fees come from a fund from which others derive benefit. The common fund doctrine is usually employed in class action suits. The prevailing plaintiff's attorneys' fees are paid from the "common fund," which of course is provided by the defendant. See *Serrano*, 20 Cal. 3d at 35, 569 P.2d at 1307, 141 Cal. Rptr. at 318-19; see also *Dawson*, *supra* note 134, at 1609-11; PEARL, *supra* note 7, § 7-4.

137. Under the equitable private attorney general doctrine, courts can award fees to litigants who prevail in actions vindicating important public policy considerations or constitutional rights. The doctrine's purpose is to encourage individuals to pursue such actions on behalf of the public. See *Serrano*, 20 Cal. App. 3d at 43-46, 569 P.2d at 1312-14, 141 Cal. Rptr. at 324-26; PEARL, *supra* note 7, § 7-13. The doctrine also provides a right for plaintiffs to recover attorneys' fees in addition to rights available under California's statutory private attorney general provision. See CAL. CIV. PROC. CODE § 1021.5 (West Supp. 1995); see also *Best v. California Apprenticeship Council*, 193 Cal. App. 3d 1448, 1462 n.12, 240 Cal. Rptr. 1, 9 n.12 (1987).

138. 179 Cal. App. 3d 318, 225 Cal. Rptr. 861 (1986).

139. *Id.* at 320-21, 225 Cal. Rptr. at 862-63.

140. *Beraksa v. Stardust Records, Inc.*, 215 Cal. App. 2d 708, 716, 30 Cal. Rptr. 504, 509 (1963).

141. *Covenant*, 179 Cal. App. 3d at 321-23, 225 Cal. Rptr. at 862-63.

142. However, as noted by the *Covenant* court, the California Supreme Court ordered the case that extended § 1717 coverage to § 3083 to be depublished. See *Kelemen Constr., Inc. v. American City Bank*, 163 Cal. App. 3d 804, 209 Cal. Rptr. 653 (1985) (depublished), cited in *Covenant Mut. Ins. Co. v. Young*, 179 Cal. App. 3d 318, 326 n.7, 225 Cal. Rptr. 861, 866 n.7 (1986).

143. *Brusso v. Running Springs Country Club, Inc.*, 228 Cal. App. 3d 92, 110, 278 Cal. Rptr. 758, 768 (1991). But see *Alcott v. M.E.V. Corp.*, 193 Cal. App. 3d 797, 800-01, 238 Cal. Rptr. 520, 522 (1987) (refusing to extend § 1717 to Corporations Code § 800).

the state's codes that limit the award of fees to one party, generally the plaintiff.¹⁴⁴

III. PROBLEMS WITH CURRENT APPLICATION OF SECTION 1717

There are numerous problems, both practical and theoretical, with the application of fee-shifting under section 1717 to contractual non-signatories. The most basic problem is the lack of authorization for such broad fee-shifting in the language or policy underlying the statute. A second fundamental problem is the inconsistency between fee-shifting based on the contractual exception to the American Rule in cases involving contractual non-signatories and the basic principles of contract law. On a more practical level, the theories used to justify fee-shifting are vastly over-inclusive. The logical inconsistencies in the theories also lead to inconsistent application and unpredictable results.

A. Lack of Statutory Basis

The fundamental flaw in applying section 1717 to cases involving contractual non-signatories is the lack of support for such fee-shifting in the language of the statute or the legislative history.¹⁴⁵ The first rule of statutory interpretation is to start with the language of the statute and apply its plain meaning.¹⁴⁶ The statute provides, in pertinent part:

In any action on a contract, where the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party, then the party who is determined to be the party prevailing on the contract, *whether he or she is the party specified in the contract or not*, shall be entitled to reasonable attorney's fees in addition to other costs.¹⁴⁷

The only language in the statute that could support fee-shifting for non-signatories is the phrase: "whether he or she is the party specified in the contract or not."¹⁴⁸ It is arguably unclear whether this phrase refers

144. *Covenant*, 179 Cal. App. 3d at 325 n.6, 225 Cal. Rptr. at 865 n.6; *see also Cuddy*, *supra* note 8, at 149-50 (naming dozens of statutory fee-shifting provisions).

145. *See supra* text accompanying notes 34-40, 64-65.

146. *See Kimmel v. Goland*, 51 Cal. 3d 202, 209, 793 P.2d 524, 527, 271 Cal. Rptr. 191, 194 (1990); *Kizer v. Hanna*, 48 Cal. 3d 1, 8, 767 P.2d 679, 683, 255 Cal. Rptr. 412, 416 (1989).

147. CAL. CIV. CODE § 1717(a) (West Supp. 1995) (emphasis added).

148. *Id.*

only to parties to the contract who are not specifically granted a right to recover attorneys' fees by the contract, or whether it could have the broader meaning of including non-parties as well.

The language of the statute, while not as clear as it could be, is not so elastic as to include non-parties within its scope. If the Legislature intended to include non-parties within the scope of section 1717, it should have used the language "whether he or she is a party to the contract or not."¹⁴⁹ By using the phrase "specified in the contract," the Legislature expressed its intent to allow all parties to a contract that included an attorneys' fees clause to recover attorneys' fees, even if the contract specifically limited that right to only certain parties.¹⁵⁰

Even if this language is ambiguous on its face, it should be interpreted in the context of the purpose of section 1717. The statute was enacted to address the problem of one-way fee-shifting in adhesion contracts.¹⁵¹ In light of this purpose, this clause means only that if the contract provides for fee-shifting in favor of only one party to the contract, such a provision will be applied to all of the parties to the contract, regardless of any specific limitation in the language of the contract. It does not mean that *any* party prevailing in litigation over a contract containing an attorneys' fees clause, whether a party to the contract or not, is entitled to fees.

Furthermore, the policy rationales for section 1717 do not apply to most of the situations currently litigated involving non-signatories. Section 1717 was designed to address a specific problem that arose in adhesion contracts affecting consumers.¹⁵² In that specific context, one party to the contract imposed one-way fee-shifting in its favor on the party in the weaker bargaining position. The statute sought to end such one-way fee-shifting provisions in adhesion contracts. Many of the cases that have extended the effect of section 1717 to non-signatories do not involve contracts with one-way fee-shifting provisions.¹⁵³ Section

149. *Canal-Randolph Anaheim, Inc. v. Wilkoski*, 78 Cal. App. 3d 477, 486, 143 Cal. Rptr. 789, 793 (1978); *Arnold v. Browne*, 27 Cal. App. 3d 386, 398, 103 Cal. Rptr. 775, 784 (1972), *disapproved* by *Reynolds Metals Co. v. Alperon*, 25 Cal. 3d 124, 129, 599 P.2d 83, 86, 158 Cal. Rptr. 1, 3 (1979).

150. *See Canal-Randolph*, 78 Cal. App. 3d at 486, 143 Cal. Rptr. at 793; *Saxon*, *supra* note 46, at 151. *But see Babcock v. Omansky*, 31 Cal. App. 3d 625, 633, 107 Cal. Rptr. 512, 518 (1973); *Scheidegger*, *supra* note 36, at 251-52.

151. *See supra* text accompanying notes 36-40.

152. REVIEW, *supra* note 37, at 36; *see also Coast Bank v. Holmes*, 19 Cal. App. 3d 581, 597 n.3, 97 Cal. Rptr. 30, 39 n.3 (1971).

153. *See, e.g., Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 377-78, 30 Cal. Rptr. 2d 536, 537-38 (1994); *North Assocs. v. Bell*, 184 Cal. App. 3d 860, 862, 229 Cal. Rptr. 305, 306 (1986); *Steve Schmidt & Co. v. Berry*, 183 Cal. App. 3d 1299, 1315, 228 Cal. Rptr. 689, 698-99 (1986); *Manier v. Anaheim Business*

1717 should not apply to contracts with two-way fee-shifting provisions at all.¹⁵⁴ In addition, many of these cases do not involve contractual overreaching by parties in superior bargaining positions; they entail sophisticated parties in highly negotiated transactions. The attorneys' fees clause in such cases is not part of an adhesion contract.¹⁵⁵

B. Conflict With Basic Contract Principles

A second basic flaw in applying section 1717 to contractual non-signatories is its logical inconsistency with elementary principles of contract law. For instance, a party should be bound only by those contractual provisions to which it has agreed.¹⁵⁶ Holding third party beneficiaries, or any non-signatories to a contract in dispute, liable for attorneys' fees pursuant to a contract to which they are a total stranger, violates this basic rule.¹⁵⁷

There are certainly valid arguments in favor of fee-shifting. The benefits of such fee-shifting may well merit abrogating contractual rights in some instances.¹⁵⁸ If generally repealing the American Rule is to be beneficial, however, it should be applied systematically, not haphazardly, as it has been done under section 1717.¹⁵⁹ All litigants should know the risks they court by engaging in a lawsuit. In the absence of a general legislative revision of the American Rule in California, courts should not require a party to pay attorneys' fees based on a provision in a contract to which it was not a party.

Ctr. Co., 161 Cal. App. 3d 503, 508, 207 Cal. Rptr. 508, 511 (1984).

154. See *Canal-Randolph*, 78 Cal. App. 3d at 485, 143 Cal. Rptr. at 793; REVIEW, *supra* note 37, at 36; Scheidegger, *supra* note 36, at 242. But see *Beneficial Standard Properties, Inc. v. Scharps*, 67 Cal. App. 3d 227, 136 Cal. Rptr. 549 (1977) (specifically applying § 1717 to a reciprocal fee-shifting provision).

155. See, e.g., *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 30 Cal. Rptr. 2d 536 (1994) (real property developer is party to multi-part agreement); *In re Vista Medical Investors, Ltd.*, 98 B.R. 29 (Bankr. S.D. Cal. 1989) (commercial real estate investors are parties to multi-part lease agreement).

156. See, e.g., CAL. CIV. CODE § 1550 (West 1982 & Supp. 1995).

157. See *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 546, 20 Cal. Rptr. 2d 193, 197 (1993).

158. See discussion *supra* at text accompanying notes 19-22.

159. For a discussion of inconsistent and haphazard revocation of the American Rule, see *infra* part III.D.

C. Over-Inclusiveness of Theories

In addition to the external inconsistency with general contract principles, both of the theories used to justify application of section 1717 to contractual non-signatories suffer from over-inclusiveness and internal inconsistencies of logic. Both theories, if followed mechanically, would require a court to award fees to a prevailing party in situations in which the party has no contractual, legal, or equitable right to them.

1. Estoppel Theory

Estoppel theory suffers from over-inclusiveness because the trigger for fee-shifting has no relationship to the contract in dispute, the governing law, or the equities of the case. Estoppel theory awards attorneys' fees to the prevailing party whenever the losing party has requested fees in its pleadings. Fees could potentially be awarded in any contract action, regardless of any other considerations.¹⁶⁰ This may be equitable in some cases, like *Reynolds*, in which the signatory party is attempting to impose contractual liability on a non-signatory.¹⁶¹ Estoppel theory creates reciprocity in such cases because the losing party would have recovered his fees had he succeeded in proving the non-signatory contractually liable.¹⁶²

In many other situations, however, mechanical application of estoppel theory will produce inequitable and non-reciprocal results. For example, applying estoppel theory would be highly inequitable when plaintiff requests fees based on a contract that does not actually contain an attorneys' fees clause. Plaintiffs may request fees by mistake, even when they are not entitled to them. In one case, the court noted that plaintiffs used a form complaint and checked the box for attorneys' fees. "[T]here is nothing in the complaint that leads to the conclusion the request for fees was based on an express contractual provision."¹⁶³ Neither was there any other basis for fees in the complaint. Plaintiffs in this case would have been liable for fees to the prevailing non-signatory under estoppel theory even though, had they won, they would have had no right of recovery.¹⁶⁴ Fee-shifting in favor of the prevailing party

160. See *supra* text accompanying notes 99-107.

161. *Reynolds Metals Co. v. Alperson*, 25 Cal. 3d 124, 127-29, 599 P.2d 83, 84-85, 158 Cal. Rptr. 1, 2-3 (1979).

162. *Id.* at 128-29, 599 P.2d at 86, 158 Cal. Rptr. at 2-3.

163. *Pilcher v. Wheeler*, 2 Cal. App. 4th 352, 356, 3 Cal. Rptr. 2d 533, 536 (1992).

164. Estoppel theory allows such an outcome because the pleadings form the basis for determining the right to recover fees, regardless of the actual facts proven at trial.

would not create reciprocity here. The non-signatory defendant could recover fees, while plaintiff could not. The resulting one-way fee-shifting would not be fair. If plaintiff requested fees only accidentally, or through use of a form complaint, she should not be punished so drastically for this error. Because of these problems, courts created an exception to estoppel theory for this situation: If the underlying contract does not contain an attorneys' fees clause and the losing party has requested fees anyway, then the losing party does not become liable for attorneys' fees to the prevailing party.¹⁶⁵

A second example of estoppel theory's over-inclusiveness arises when a contract is unenforceable because it is illegal. If the contract is illegal, the signatory could never, as a practical matter, have prevailed. The lack of reciprocity and unfairness to the losing party discussed *supra* also apply here. Courts therefore reasoned that, if the contract in dispute is unenforceable on grounds of illegality, the attorneys' fees clause is also unenforceable.¹⁶⁶ One court explained this exception as follows: "[W]here neither party can enforce the agreement there is no need for a mutual right to attorney's fees."¹⁶⁷ When only some of the contract's terms are unenforceable, but the contract itself is enforced, fees may be awarded, however.¹⁶⁸

A third example occurs when a party brings a declaratory relief action to determine its rights and obligations under a contract to which it is not a signatory. If the non-signatory plaintiff includes a demand for fees in the pleadings without any contractual basis for fee-shifting, he would

See Jones v. Drain, 149 Cal. App. 3d 484, 489, 196 Cal. Rptr. 827, 830-31 (1983); *see also supra* text accompanying notes 99-107.

165. *See Pilcher*, 2 Cal. App. 4th at 356, 3 Cal. Rptr. at 536; *Green v. Mt. Diablo Hosp. Dist.*, 207 Cal. App. 3d 63, 76, 254 Cal. Rptr. 689, 697 (1989); *see also Myers Bldg. Indus., Ltd. v. Interface Technology, Inc.*, 13 Cal. App. 4th 949, 962 n.12, 17 Cal. Rptr. 2d 242, 250 n.12 (1993) (holding that the prevailing party is not entitled to fees under estoppel theory where the underlying contract is an indemnity agreement that provides for fees relating only to third party claims); *Alhambra Redev. Agency v. Transamerica Fin. Servs.*, 212 Cal. App. 3d 1370, 1380-82, 261 Cal. Rptr. 248, 253-54 (1989) (holding that when the parties had waived the underlying right to attorneys' fees, no estoppel could apply).

166. *See Bovard v. American Horse Enters., Inc.*, 201 Cal. App. 3d 832, 843, 247 Cal. Rptr. 340, 346 (1988); *Geffen v. Moss*, 53 Cal. App. 3d 215, 227, 125 Cal. Rptr. 687, 694 (1975).

167. *Care Constr., Inc. v. Century Convalescent Ctrs.*, 54 Cal. App. 3d 701, 707, 126 Cal. Rptr. 761, 765 (1976).

168. *South Bay Transp. Co. v. Gordon Sand Co.*, 206 Cal. App. 3d 650, 661, 253 Cal. Rptr. 753, 759-60 (1988).

then become liable for fees if he lost. Such automatic application of estoppel theory also causes non-reciprocal and inequitable results.¹⁶⁹

Numerous other exceptions to estoppel theory would have to be created whenever a court determines that the automatic application of section 1717 is inequitable. Indeed, several courts have specifically rejected estoppel theory in favor of mutuality theory when faced with this problem.¹⁷⁰

2. Mutuality Theory

Mutuality theory also suffers from over-inclusiveness because of its very nature. Under mutuality theory, a court must look to the losing party's right to recover attorneys' fees in determining the prevailing party's reciprocal right to recover attorneys' fees.¹⁷¹ As a consequence, whenever a court creates a new right to attorneys' fees under section 1717, it generates an unintended "domino effect" of fee awards. In later cases, the first case has established a legal right to recover fees in favor of the prevailing party in a factual situation similar to the original case. If that party should lose in the second case, she is then liable for fees under mutuality theory because she could have actually recovered her fees if she had prevailed pursuant to the new rule created in the first case. The prevailing party in the second case then has a right to recover fees.¹⁷² This process could create a right to recover attorneys' fees for many parties who have no pre-existing legal, contractual, or equitable right to fee-shifting. Such new rules of fee-shifting could also contradict existing legal rules regarding liability for

169. See *Leach v. Home Sav. & Loan Ass'n*, 185 Cal. App. 3d 1295, 1306-07, 230 Cal. Rptr. 553, 560-61 (1986), where the court refused to apply estoppel theory to a losing non-signatory plaintiff who brought a declaratory relief action requesting fees. The court applied mutuality theory instead, and did not award fees.

170. See, e.g., *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 548, 20 Cal. Rptr. 2d 193, 198 (1993); *Myers Bldg. Indus., Ltd. v. Interface Technology, Inc.*, 13 Cal. App. 4th 949, 962 n.12, 17 Cal. Rptr. 2d 242, 250 n.12 (1993); *Alhambra Redev. Agency v. Transamerica Fin. Servs.*, 212 Cal. App. 3d 1370, 1380-82, 261 Cal. Rptr. 248, 253-54 (1989); *Leach*, 185 Cal. App. 3d at 1307, 230 Cal. Rptr. at 561.

171. See *supra* note 116 and accompanying text.

172. For example, as discussed *supra* in text accompanying notes 123-30, *Saucedo* created a right on behalf of the non-assuming grantee to recover her attorneys' fees from the trustee based on mutuality. *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 168 Cal. Rptr. 552 (1980). *Santa Clara Sav.* subsequently held that this right to fees was reciprocal in favor of the trustee in a non-assuming grantee situation. *Santa Clara Sav. & Loan Ass'n v. Pereira*, 164 Cal. App. 3d 1089, 1098, 211 Cal. Rptr. 54, 59 (1985). See *infra* text accompanying notes 183-85. Other examples are discussed *infra* at text accompanying notes 174-77.

attorneys' fees.¹⁷³ This problem has arisen in at least three of the four factual situations in which fee-shifting generally occurs in cases involving contractual non-signatories. It could potentially happen every time a court creates a right to fees where none existed before.

For example, the problem can occur when a signatory plaintiff seeks to enforce a contract against a non-signatory defendant who asserts that the contract is unenforceable. If the non-signatory prevails, he could recover fees pursuant to section 1717.¹⁷⁴ As stated above, mutuality only requires the *possibility* that the losing party could have prevailed, regardless of how slight the chance.¹⁷⁵ If the signatory were to prevail instead, in a later case involving the same facts, he could recover his attorneys' fees under mutuality theory. The authority created by the earlier cases creates a reciprocal right to fees for both parties in the later action. This is true even in cases where the signatory prevails on the contract despite the non-signatory defendant's lack of privity of contract with the plaintiff. This could occur when a lessee of real property sues to enforce the terms of the lease against a party who acquired the property through foreclosure. The parties are not in privity of contract, but the signatory lessor has a right to continue to occupy the property because of privity of estate.¹⁷⁶ In such cases, mutuality theory turns a situation in which neither party has a right to recover attorneys' fees into one in which both parties can recover their fees.¹⁷⁷ This is the wrong result because the non-signatory never agreed to any of the terms of the contract, including the attorneys' fees provision. He should, therefore, not be bound by the terms of that contract.

The third party beneficiary scenario is another area in which mutuality theory can create an entitlement to fees in favor of parties with no pre-existing legal, contractual, or equitable right to them. A third party beneficiary to a contract is not a signatory to the contract, but she can

173. See, e.g., *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 596-97, 542 P.2d 981, 985-86, 125 Cal. Rptr. 557, 561-62 (1975) (holding that trustee cannot recover any obligation from a non-assuming grantee).

174. See, e.g., *Care Constr. v. Century Convalescent Ctrs., Inc.*, 54 Cal. App. 3d 701, 707, 126 Cal. Rptr. 761, 765 (1976).

175. See *supra* note 121 and accompanying text.

176. *Salisbury v. Shirley*, 66 Cal. 223, 225-26, 1 P. 104, 106 (1884); see also 42 CAL. JUR. 3D *Landlord & Tenant* § 57, at 76 (1978).

177. See *supra* note 172.

bring suit to enforce her rights under the agreement.¹⁷⁸ In some cases, a third party beneficiary who seeks to enforce her rights under a contract containing an attorneys' fees clause is entitled to recover her attorneys' fees.¹⁷⁹ If the third party beneficiary had lost the action instead, mutuality theory would make the right to recover attorneys' fees reciprocal. This is the wrong result because the third party beneficiary never agreed to any of the terms of the contract, including the attorneys' fees provision. The third party beneficiary becomes obligated by the attorneys' fees provision of the contract merely because she receives some benefit from the contract. Some courts have disagreed with this result,¹⁸⁰ but it remains a logical consequence of mutuality theory.¹⁸¹

The non-assuming grantee scenario is also subject to the unjustified results of mutuality theory. The theory entitles the non-assuming grantee to recover fees from the trustee of the pre-existing deed of trust in a foreclosure action. Using the same analysis when the trustee prevails in such an action instead and subsequently seeks attorneys' fees, the court must first determine if the losing non-assuming grantee could have recovered his fees if he had prevailed. As discussed above, prior courts applying mutuality theory have created such a right in favor of the non-assuming grantee.¹⁸² The trustee is therefore entitled to recover fees under mutuality theory because the right is reciprocal. At least one court has followed this syllogism and granted fees to a prevailing trustee in an action against a non-assuming grantee pursuant to section 1717.¹⁸³ Prior to the application of section 1717, the trustee had no legal right to recover attorneys' fees from a non-assuming grantee because a non-assuming grantee is not personally liable for obligations created by the pre-existing note and deed of trust.¹⁸⁴ Thus, by applying mutuality theory, the courts created a new entitlement on behalf of both non-assuming grantees and trustees in actions regarding the deed of trust.¹⁸⁵

178. See CAL. CIV. CODE § 1559 (West 1982 & Supp. 1995).

179. See *Steve Schmidt & Co. v. Berry*, 183 Cal. App. 3d 1299, 1315-17, 228 Cal. Rptr. 689, 698-700 (1986); see also *infra* text accompanying notes 200-02.

180. See *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 546, 20 Cal. Rptr. 2d 193, 197 (1993).

181. See *infra* text accompanying notes 200-07.

182. See *supra* notes 123-30 and accompanying text.

183. *Santa Clara Sav. & Loan Ass'n v. Pereira*, 164 Cal. App. 3d 1089, 1098, 211 Cal. Rptr. 54, 59 (1985).

184. *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 596-97, 542 P.2d 981, 985-86, 125 Cal. Rptr. 557, 561-62 (1975).

185. See *Santa Clara Sav. & Loan Ass'n v. Pereira*, 164 Cal. App. 3d 1089, 1098, 211 Cal. Rptr. 54, 59 (1985); *Saucedo v. Mercury Sav. & Loan Ass'n*, 111 Cal. App. 3d 309, 168 Cal. Rptr. 552 (1980).

In addition to these three typical kinds of cases, section 1717's effects could possibly extend to non-contractual one-way fee-shifting rules. This creates even greater disruptions to the pre-existing scheme of rights to attorneys' fees. The statutory and equitable fee-shifting provisions are intended to encourage litigation in certain circumstances and by certain parties, generally plaintiffs.¹⁸⁶ These rules permit individuals with relatively small interests in the outcome of litigation to enforce the rights of others with similar interests. The interests of each aggrieved individual may be too small to make pursuing litigation economically viable.¹⁸⁷ Attorneys' fees alone could well outweigh any possible benefit for the individual.¹⁸⁸ Only by creating a possibility of recovering fees does a lawsuit become practical in many cases.¹⁸⁹ Making fee-shifting reciprocal would create a tremendous disincentive for any individual plaintiff to proceed with such an action.¹⁹⁰ Not only would these potential plaintiffs bear the risk of not recovering their own attorneys' fees, but they could suffer the huge risk of becoming liable for the defendants' fees as well. The risk would likely eliminate such suits in all but the most compelling cases.¹⁹¹

D. Inconsistent Results

The over-inclusiveness and incoherence of the theories supporting fee-shifting for contractual non-signatories pursuant to section 1717 create exceptions and inconsistencies in the application of section 1717, as courts strain to provide a right to fees they think are merited. Both estoppel and mutuality theories suffer from inconsistent results that make their application to particular factual situations largely subject to the preferences of individual judges. Although the manifestations of this problem are different for each theory, litigants have very little certainty

186. See Harold J. Krent, *Explaining One-Way Fee Shifting*, 79 VA. L. REV. 2039, 2045-75 (1993), which discusses the effect of eliminating one-way fee-shifting statutes at the federal level. The same analysis applies at the state level. See also *Covenant Mut. Ins. Co. v. Young*, 179 Cal. App. 3d 318, 326, 225 Cal. Rptr. 861, 866 (1986).

187. See Krent, *supra* note 186, at 2050.

188. *Id.* at 2051.

189. *Id.* at 2048.

190. See Mause, *supra* note 11, at 35-36.

191. *Id.*; *Covenant Mut. Ins. Co. v. Young*, 179 Cal. App. 3d 318, 326, 225 Cal. Rptr. 861, 866 (1986).

about the result in any given case. This creates practical problems for courts and litigants, including increased litigation over attorneys' fees.

1. Estoppel Theory

Estoppel theory suffers from indeterminacy and inconsistency because of its exceptions. As discussed above, there are two recognized exceptions to estoppel theory: courts will not award attorneys' fees to the prevailing party when the underlying contract is not legally enforceable,¹⁹² nor when the contract does not actually contain an attorneys' fees provision.¹⁹³ Additional exceptions might be necessary: for example, when a party requests attorneys' fees based on a declaratory relief action when the contract gives no right to attorneys' fees.¹⁹⁴

While such exceptions to estoppel theory make its application more equitable, they are totally inconsistent with its logic. Because estoppel is based on the parties' allegations and not on the evidence proven at trial, the baselessness of the claim to attorneys' fees should be irrelevant.¹⁹⁵ Logically, estoppel theory posits that the more frivolous the losing party's claim to attorneys' fees, the greater the prevailing party's right to recover them. Estoppel theory should permit—indeed encourage—fee-shifting when the losing party could not possibly have recovered his own attorneys' fees. This would appear to be the most obvious case for imposing fees, and the truest test of estoppel theory.

In addition, these exceptions make application of estoppel theory inconsistent and unpredictable. It is difficult to justify the distinction between a contract held unenforceable on grounds of illegality and a contract held unenforceable on any other ground. In both cases, the signatory party has unsuccessfully attempted to enforce a contract vis-à-vis a non-signatory. In both cases, the signatory party would have recovered fees under section 1717 had she prevailed. Yet, in the case of illegality, the courts have held that an award of attorneys' fees is impossible,¹⁹⁶ while in other cases it is merely unlikely.

This distinction between "impossible" and "unlikely" is arbitrary. What if the question of a contract's illegality was an extremely close legal question that could have gone the other way? As a practical

192. See *supra* text accompanying notes 166-68.

193. See *supra* text accompanying notes 163-65.

194. See *supra* text accompanying note 169.

195. See *Manier v. Anaheim Business Ctr. Co.*, 161 Cal. App. 3d 503, 508, 207 Cal. Rptr. 508, 511 (1984); *Jones v. Drain*, 149 Cal. App. 3d 484, 489, 196 Cal. Rptr. 827, 830-31 (1983).

196. See, e.g., *Care Constr., Inc. v. Century Convalescent Ctrs., Inc.*, 54 Cal. App. 3d 701, 707, 126 Cal. Rptr. 761, 765 (1976).

matter, the signatory party's right to recover attorneys' fees is merely unlikely in that case, not impossible. The same argument could be made as to any other exception to estoppel theory. The theory would theoretically entitle a party to recover attorneys' fees any time he requested them, his contentions were correct, and he prevailed. The likelihood of any party prevailing is a matter of degree. In some cases the court may find that its decision is inevitable. In other cases, that result is merely likely or probable. Such a distinction is arbitrary.¹⁹⁷ The courts' refusal to carry estoppel theory through to its logical conclusion highlights its weakness as a basis for allowing attorneys' fees to non-signatories under section 1717. Courts will create new exceptions in every case in which it appears inequitable to follow the theory.

2. Mutuality Theory

Mutuality theory also suffers from inconsistent application and results, mirroring the problem with estoppel theory. Under mutuality theory, the prevailing party can recover fees only if the losing party would actually have recovered attorneys' fees had she prevailed.¹⁹⁸ Ultimately, the decision whether the losing party could have recovered fees is subjective.¹⁹⁹ One court may decide that the possibility of the losing party recovering fees is totally speculative and therefore would deny fees to the prevailing party. In other cases with similar facts, courts may weigh the evidence differently and find that the losing party could actually have recovered attorneys' fees and therefore award them to the prevailing party.

Third party beneficiary cases are rife with such inconsistencies. In some cases, third party beneficiaries have recovered fees.²⁰⁰ Later

197. For example, this problem could arise in the non-assuming grantee situation. As noted *supra* note 124 in *Cornelison*, a prevailing trustee has no right to recover attorneys' fees from the non-assuming grantee. *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 596-97, 542 P.2d 981, 985-86, 125 Cal. Rptr. 557, 561-62 (1975). A trustee's request for fees would be impossible and thus should not trigger any reciprocal right to fees under estoppel theory. But, as discussed *supra* at text accompanying note 185, the *Periera* court held that a trustee may recover attorneys' fees from a non-assuming grantee. *Santa Clara Sav. & Loan Ass'n v. Pereira*, 164 Cal. App. 3d 1089, 1098, 211 Cal. Rptr. 54, 59 (1985). See generally text accompanying notes 182-85.

198. See *supra* text accompanying note 116.

199. See *infra* text accompanying notes 200-24.

200. See *supra* notes 85-86 and accompanying text.

cases have then made the rule reciprocal and held third party beneficiaries liable for attorneys fees based on mutuality.²⁰¹ In other cases, third party beneficiaries have not been able to recover their attorneys' fees, and then later cases have made that rule reciprocal.²⁰² There is no justifiable distinction between these different cases.

Under one line of cases, courts have awarded fees to the prevailing party when a sub-tenant of real property sues the master lessor of the property based on the master lease, which contained an attorneys' fees provision. In the first such case, the sub-tenant prevailed. The court held that the sub-tenant was entitled to recover fees under section 1717 because it was a third party beneficiary of the master lease, and the suit was based on the contract.²⁰³ In the next case that involved sub-tenants and master lessors contesting the terms of the master lease, the master lessor prevailed.²⁰⁴ The first case created authority entitling the sub-tenants to recover fees if they prevailed.²⁰⁵ In the second case, the lessors prevailed and mutuality entitled them to recover fees.²⁰⁶ This line of cases established that third party beneficiaries are entitled to the benefits of an attorneys' fees clause in a contract to which they are not a party.²⁰⁷ This right is made reciprocal by mutuality theory.

In another line of cases involving third party beneficiaries, however, courts have not allowed fee-shifting. In *Super 7 Motel Assocs. v. Wang*, the court did not award attorneys' fees to a prevailing defendant claiming to be a third party beneficiary of a real property purchase

201. See, e.g., *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 383-84, 30 Cal. Rptr. 2d 536, 541-42 (1994).

202. See, e.g., *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 546, 20 Cal. Rptr. 2d 193, 197 (1993).

203. *In re Vista Medical Investors, Ltd.*, 98 B.R. 29, 34 (Bankr. S.D. Cal. 1989).

204. *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 30 Cal. Rptr. 2d 536 (1994).

205. *In re Vista Medical Investors, Ltd.*, 98 B.R. 29 (Bankr. S.D. Cal. 1989).

206. *Real Property Servs. Corp.*, 25 Cal. App. 4th at 383-84, 30 Cal. Rptr. 2d at 541-42. In contrast to the sub-tenant scenario in *Vista Medical* and *Real Property*, a tenant could alternatively assign her interest in the real property to a third party, without making her a sub-tenant, and without the lessor's consent, causing quite a different outcome. In one such scenario, the court refused to award fees to the assignee who prevailed in an unlawful detainer action initiated by the lessor. To differentiate the treatment of assignees as compared to sub-tenants, the court held that an assignee was not a known third party beneficiary of the master lease, and therefore could not take advantage of the attorneys' fees clause in that contract. *Artesia Medical Dev. Co. v. Regency Assocs., Ltd.*, 214 Cal. App. 3d 957, 266 Cal. Rptr. 657 (1989). Cf. *Wilson's Heating & Air Cond. v. Wells Fargo Bank*, 202 Cal. App. 3d 1326, 1334, 249 Cal. Rptr. 553, 558 (1988) (recognizing that third party beneficiaries might be entitled to recover fees under § 1717, but refusing to award fees on other grounds).

207. *Vista Medical*, 98 B.R. at 34.

contract.²⁰⁸ It categorically rejected the claim that a third party beneficiary is either entitled to recovery of or liability for attorneys' fees under section 1717:

[There is] no authority suggesting a third party beneficiary has any right other than to collect the benefits the contracting parties agreed to confer on him. Indeed, the basic premise underlying attorney fee clauses, i.e., a party is not liable for attorney fees unless he agrees to the clause, is inconsistent with [the attorneys' fees] theory, because a third party beneficiary does not participate in reaching the agreement.²⁰⁹

This rule potentially creates reciprocal protection from liability for fees in later cases where the third party beneficiary loses.

The case law does not logically explain why third party beneficiaries of real property leases are treated differently from third party beneficiaries of purchase and sale agreements under mutuality theory.²¹⁰ Nor is there any way to predict how a third party beneficiary in any other factual situation would fare. All mutuality theory will predict is the reciprocity between a third party beneficiary's right to recover attorneys' fees and its liability for fees.²¹¹

A second area of uncertainty under mutuality theory exists in cases applying the non-assuming grantee standard of practical liability for fee-shifting. As discussed above in the non-assuming grantee cases, courts have held that, despite the non-assuming grantee's lack of legal obligation to pay the prevailing trustee's attorneys' fees, he must, as a practical matter, pay such fees in order to protect his interest in the property. Accordingly, under mutuality theory, the non-assuming grantee can recover attorneys' fees if he prevails.²¹²

This same line of reasoning has been applied in other circumstances with limited success. In one such case, *Clar v. Cacciola*,²¹³ the parties

208. *Super 7 Motel Assocs. v. Wang*, 16 Cal. App. 4th 541, 546, 20 Cal. Rptr. 2d 193, 197 (1993).

209. *Id.*

210. *But see Steve Schmidt & Co. v. Berry*, 183 Cal. App. 3d 1299, 228 Cal. Rptr. 689 (1986) (broker was a third party beneficiary of a real property purchase agreement who recovered fees under estoppel theory); *Jones v. Drain*, 149 Cal. App. 3d 484, 196 Cal. Rptr. 827 (1983) (third party beneficiary of a real property purchase agreement was held liable for fees under estoppel theory).

211. *Real Property Servs. Corp. v. City of Pasadena*, 25 Cal. App. 4th 375, 383-84, 30 Cal. Rptr. 2d 536, 541-42 (1994).

212. *See supra* text accompanying notes 123-30.

213. 193 Cal. App. 3d 1032, 238 Cal. Rptr. 726 (1987).

had competing claims about the priority of two deeds of trust on real property. Each party claimed that his own interest in the property was the second deed of trust and that the other party's deed of trust was in third position.²¹⁴ Defendants prevailed and claimed a right to recover attorneys' fees without privity of contract between the parties.²¹⁵ Defendants argued that, had they lost, plaintiffs would have then been able to recover attorneys' fees through a foreclosure proceeding, just as in the case of the non-assuming grantee.²¹⁶ According to this argument, plaintiffs' attorneys' fees would have been added to the secured debt under the terms of the deed of trust, which the defendants would have had to pay to protect their equity in the property. The court rejected this theory and held that the defendants' potential obligation to pay fees was too speculative.²¹⁷ The court reasoned that defendants may or may not have decided to redeem the property if plaintiffs had prevailed and had then instituted foreclosure proceedings.²¹⁸

This decision depended on the court making assumptions about the prevailing party's monetary interest in the property and the likely actions of the losing party if he or she had prevailed. These assumptions are totally speculative. The court's holding was based largely on its subjective interpretation of the likely course of events in this counterfactual scenario.²¹⁹

In practical liability and third party beneficiary cases, courts must make very fact specific analyses about the prevailing party's potential liability had she lost.²²⁰ Nearly identical factual circumstances could yield entirely different results. The danger with analyzing the prevailing

214. *Id.* at 1033, 238 Cal. Rptr. at 726.

215. *Id.* at 1037, 238 Cal. Rptr. at 729.

216. *Id.* at 1037-38, 238 Cal. Rptr. at 729.

217. *Id.* at 1039, 238 Cal. Rptr. at 730.

218. *Id.* In a similar case, plaintiffs were the owners of real property and defendant was a lender with a security interest in the property that derived from the prior owner, not the plaintiffs. *Alhambra Redev. Agency v. Transamerica Fin. Servs.*, 212 Cal. App. 3d 1370, 261 Cal. Rptr. 248 (1989). When the property was taken by eminent domain, the parties disputed their relative rights to the proceeds of the condemnation award. The property owners prevailed and attempted to recover attorneys' fees based on a contract provision contained in the prior owner's deed of trust on the property. The prevailing party argued that, as a practical matter, it would have been liable for fees had it lost because the trustee's attorneys' fees would have come from the condemnation proceeds pursuant to a statutory scheme governing eminent domain proceedings. The court rejected this argument because it did not find that the prevailing party could actually have been liable for fees if it had lost, based on the facts of that case.

219. *Clar*, 193 Cal. App. 3d at 1039, 238 Cal. Rptr. at 730.

220. *See, e.g., Smith v. Kreuger*, 150 Cal. App. 3d 752, 757, 198 Cal. Rptr. 174, 176 (1983).

party's practical liability is subjectivity and lack of guidelines for the courts to follow.²²¹

3. Resulting Problems

The inconsistent application of section 1717 will generate other practical problems for courts and for litigants. First, it will increase the costs of litigation. Parties will be forced to litigate not only the substance of their disputes but also their rights to recover attorneys' fees. The burden on the courts will increase as more parties seek to appeal inconsistent attorneys' fees awards.²²²

Second, uncertainty and inconsistent results under section 1717 may undermine the judiciary's legitimacy in settling civil disputes.²²³ Litigants will see courts awarding fees based solely upon the equities of the cases, irrespective of the parties' contractual obligations. If judges were simply to rely upon their subjective perceptions of fairness in the circumstances of individual cases, parties may hesitate to trust the whims of such an overtly subjective system.²²⁴ Difficult to verify or quantify, such hesitancy is a logical conclusion if parties seek predictable results from a dispute resolution system. The lack of such predictability may lower confidence in the judicial system.

221. In one common situation, real estate brokers are third party beneficiaries of real property agreements containing attorneys' fees clauses. In *Super 7 Motel Assocs.*, the court held that a real estate broker in this situation could not recover his fees under § 1717 because "he had no contractual obligations or interest in the sale of the property." *Super 7 Motel Assocs v. Wang*, 16 Cal. App. 4th 541, 545, 20 Cal. Rptr. 2d 193, 197 (1993). *But see Jones v. Drain* 149 Cal. App. 3d 484, 487, 196 Cal. Rptr. 827, 829 (1983) (awarding fees to real estate broker in same situation, using estoppel theory); *Steve Schmidt & Co. v. Berry*, 183 Cal. App. 3d 1299, 1317, 228 Cal. Rptr. 689, 700 (1986) (same).

222. See POSNER, *supra* note 16, at 541 (noting that uncertainty generates litigation, especially appellate litigation); *id.* at 572 (noting that the British Rule creates satellite litigation regarding attorneys' fees); Mause, *supra* note 11, at 48; see also Krent, *supra* note 186, at 2082-88.

223. See Owen M. Fiss, *The Supreme Court, 1978 Term - Foreword: The Forms of Justice*, 93 HARV. L. REV. 1, 38 (1979), which argues that the legitimacy of the judiciary depends on its ability to render "competent" decisions that create social value.

224. This problem has been discussed extensively in the area of constitutional interpretation. See, e.g., Owen M. Fiss, *Objectivity and Interpretation*, 34 STAN. L. REV. 739, 763 (1982) (discussing the need for objective interpretation of the Constitution); RONALD DWORKIN, *LAW'S EMPIRE* 45-87 (1986) (making similar arguments).

IV. ARGUMENTS IN FAVOR OF FEE-SHIFTING FOR CONTRACTUAL NON-SIGNATORIES UNDER SECTION 1717

A number of arguments favor fee-shifting under section 1717 for contractual non-signatories: fee-shifting is more equitable, it encourages meritorious claims and discourages frivolous claims, it properly compensates prevailing parties, it punishes losing parties who bring frivolous claims, and it encourages settlement. It is important to explore these arguments in order to weigh the benefits against the problems with applying section 1717 to non-signatories.

A. Equity

Equity is the most important argument in favor of the application of section 1717 to contractual non-signatories. This rationale is cited again and again in the cases that allow such fee-shifting.²²⁵ It is true that in some cases the losing party could have recovered attorneys' fees from the prevailing party if the loser had prevailed.²²⁶ Therefore, it would be unfair to deny the prevailing party that same right. Section 1717's undoubted purpose was to make attorneys' fees awards more equitable and ensure that one-way fee-shifting did not occur under the contractual exception to the American Rule.²²⁷

The right to attorneys' fees, however, is a two-edged sword that can generate as much inequity as equity. For every non-signatory who recovers fees based on an extension of section 1717, another non-signatory in a different case potentially becomes liable for attorneys' fees based on mutuality.²²⁸ In some ways, this result is equitable. It allows a wronged party to recover the full measure of its damages. In other ways, it is inequitable. It requires a party who has not agreed to any such contractual provision to be liable for the prevailing party's attorneys' fees. The balance between these factors will vary with each case. Equity is not always a strong argument in favor of fee-shifting for contractual non-signatories under section 1717.

225. See, e.g., *Brusso v. Running Springs Country Club, Inc.*, 228 Cal. App. 3d 92, 110, 278 Cal. Rptr. 758, 767 (1991); *Jones*, 149 Cal. App. 3d at 489, 196 Cal. Rptr. at 830; *Lewis v. Alpha Beta Co.*, 141 Cal. App. 3d 29, 189 Cal. Rptr. 840 (1983).

226. See, e.g., *Reynolds Metals Co. v. Alperson*, 25 Cal. 3d 124, 129, 599 P.2d 83, 86, 158 Cal. Rptr. 1, 3 (1979); *Babcock v. Omansky*, 31 Cal. App. 3d 625, 633, 107 Cal. Rptr. 512, 518 (1973).

227. See *supra* text accompanying notes 36-40.

228. See *supra* text accompanying notes 174-85, 203-07.

B. Creating Proper Incentives and Disincentives For Litigation

A second argument in favor of applying section 1717 to contractual non-signatories is based on the idea that adoption of the British Rule discourages frivolous claims and encourages small but meritorious claims.²²⁹ Such a rule would encourage a contractual non-signatory party to litigate a meritorious contract claim, even if costly to do so, because she could recover attorneys' fees if she prevailed. Likewise, a party would not bring a frivolous claim, even with huge resources at her disposal, because she would have to pay the winning side's attorneys' fees if she lost.²³⁰ Some have argued that if this theory is true in the broader context, it should also be true in the specific case of section 1717.²³¹ Furthermore, this argument is consistent with the policies underlying section 1717 of encouraging poorer individuals to vindicate their rights through the courts and deterring wealthy and powerful litigants from intimidating poorer opponents by filing frivolous actions.²³²

Further analysis, however, reveals that such wider fee-shifting may actually discourage claims by poorer individual litigants, in conflict with the purpose of section 1717.²³³ Poorer individual litigants are likely to be more risk averse than institutions and wealthier individuals because the poor can ill afford to incur a substantial judgment for attorneys' fees.²³⁴ Therefore, the deterrent effect of fee-shifting will be greater on poorer litigants and they will file fewer claims under the British Rule than under the American Rule.²³⁵ This problem does not occur when the statute merely makes one-way fee-shifting provisions reciprocal, because turning a one-way fee-shifting provision (which usually benefits

229. See authorities cited *supra* notes 20-21.

230. See *supra* note 21.

231. See Saxon, *supra* note 46, at 153.

232. See *supra* text accompanying notes 36-40.

233. *Covenant Mut. Ins. Co. v. Young*, 179 Cal. App. 3d 318, 326, 225 Cal. Rptr. 861, 866 (1986).

234. *Id.* at 326 n.8, 225 Cal. Rptr. at 866 n.8 (citing Michael Zander, *Costs of Litigation—A Study in the Queens Bench Division*, 72 L. SOC'Y'S GAZETTE 679, 680 (1975)).

235. See Marc Galanter, *Why The "Haves" Come Out Ahead: Speculations on Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 99-100 & n.11 (1974); Mause, *supra* note 11, at 36; *infra* text accompanying notes 277-79.

a wealthy corporation or individual) into a reciprocal two-way fee-shifting provision can only benefit the newly empowered party, regardless of wealth.²³⁶ When the statute is applied to cases in which there is no fee-shifting provision in effect, however, new forces come into play. The new fee-shifting rule can actually deter poor individuals from seeking to vindicate their rights through the courts.²³⁷

Furthermore, the assumption that wider fee-shifting under section 1717 would efficiently affect primary litigation conduct is subject to some doubt given its current inconsistent application. For example, a third party beneficiary of a contract containing an attorneys' fees clause has no indication as to whether it would recover fees under current law.²³⁸ Fee-shifting under section 1717 in cases involving contractual non-signatories is thus unlikely to have any deterrent effect because it is applied in such an inconsistent manner. Most attorneys, let alone most parties, have no idea when courts will apply section 1717 to contractual non-signatories under the current rules. It is therefore extremely unlikely to deter potential litigants from pursuing an action.²³⁹ Consequently, applying section 1717 to contractual non-signatories will have a minimal effect on individual decisions about filing actions. Detering frivolous litigation fails as a strong argument in favor of fee-shifting in cases involving contractual non-signatories.

C. Compensation

Compensating litigants for enduring frivolous contract claims or defenses is a third argument in favor of applying section 1717 to non-signatories. If a prevailing plaintiff must pay her own attorneys' fees out of the award, she is not made whole by the judgment.²⁴⁰ It may, in fact, cost more to win a judgment than the award itself.²⁴¹ Likewise, a prevailing defendant has to bear potentially huge costs of litigation incurred in defending a frivolous claim.²⁴² Based on these arguments, some courts have held that a prevailing litigant is equitably

236. See *supra* text accompanying notes 186-91.

237. *Covenant*, 179 Cal. App. 3d at 326-28, 225 Cal. Rptr. at 866-68.

238. See *supra* text accompanying notes 203-11.

239. See Mause, *supra* note 11, at 46 (noting that uncertain results corrode the deterrent effect of fee-shifting on frivolous lawsuits).

240. See *supra* note 19.

241. See discussion *supra* note 2.

242. See *supra* note 19.

entitled to compensation when its opponent alleges a losing contract claim or defense.²⁴³

This argument falls short when applied to section 1717. Fee-shifting under section 1717 does not occur when the action is totally frivolous and such compensation is most deserving: where the contract fails for illegality or where the contract does not even contain an attorneys' fees clause.²⁴⁴ Furthermore, if a claim is truly frivolous, the defendant already has the remedy of seeking sanctions or filing a malicious prosecution action.²⁴⁵ These devices also have the necessary due-process limitations to prevent their overuse and abuse by the courts and by litigants.²⁴⁶

Finally, as a general matter, it is not clear that, simply because a party prevails in a lawsuit, he is logically or equitably entitled to recover attorneys' fees.²⁴⁷ A losing party may have been fully justified in pursuing an ultimately losing claim or defense. He may have been seeking to establish a novel legal claim or defense in good faith.²⁴⁸ Quite possibly, a party could prevail based on the thinnest of legal technicalities while the equities all lie with the losing party.²⁴⁹ In sum, the losing party has not necessarily caused any harm to the prevailing party, even though the latter recovered a judgment. Therefore, it is not uniformly true that the prevailing party is entitled to compensation from the losing party for attorneys' fees. A blanket rule providing for fee-shifting on the basis of the compensation rationale is not compelling.

243. See *North Assocs. v. Bell*, 184 Cal. App. 3d 860, 865, 229 Cal. Rptr. 305, 308 (1986); *Jones v. Drain*, 149 Cal. App. 3d 484, 490, 196 Cal. Rptr. 827, 830 (1983).

244. See *supra* text accompanying notes 163-68.

245. See, e.g., *On v. Cow Hollow Properties*, 222 Cal. App. 3d 1568, 272 Cal. Rptr. 535 (1990) (prevailing party sought fees not only based on § 1717, but as sanctions as well).

246. For example, § 128.7 of the California Code of Civil Procedure provides that sanctions may only be awarded after the sanctioned party has an opportunity for a hearing devoted to the sanctions motion. CAL. CIV. PROC. CODE § 128.7 (West Supp. 1995). The California Supreme Court addressed the due process safeguards necessary for an award of sanctions. See *Bauguess v. Paine*, 22 Cal. 3d 626, 638, 586 P.2d 942, 949, 150 Cal. Rptr. 461, 468 (1978). See also *Caldwell v. Samuels Jewelers*, 222 Cal. App. 3d 970, 976, 272 Cal. Rptr. 126, 129-30 (1990) (noting that due process requires notice and an opportunity for a hearing prior to imposition of sanctions).

247. See *Mause*, *supra* note 11, at 28-30.

248. See *id.* at 46.

249. See *id.* at 28-30; *Rowe*, *supra* note 13, at 655.

D. Punishment of Frivolous Litigants

Using section 1717 to punish parties engaging in frivolous litigation is a fourth argument in favor of extending fee-shifting to contractual non-signatories.²⁵⁰ In *On v. Cow Hollow Properties*,²⁵¹ the court specifically granted fees to the prevailing party on the alternative bases of section 1717 and California Code of Civil Procedure section 128.5.²⁵² The latter provides for an award of attorneys' fees in cases of bad faith litigation tactics.²⁵³

The equitable basis of section 1717 could easily allow courts to use it as a tool for punishing litigants for acting in bad faith or for bringing a frivolous claim,²⁵⁴ consistent with the general arguments supporting broad adoption of the British Rule.²⁵⁵ But, while deterring frivolous lawsuits and compensating litigants for enduring such actions is an unarguably lofty goal, it would be an improper use of section 1717. The legislature intended section 1717 only to make the contractual right of the prevailing party to recover attorneys' fees equally available to both parties to a contract.²⁵⁶ Courts may not award attorneys' fees as sanctions absent specific statutory authority.²⁵⁷ Without appropriate statutory safeguards and guidelines to limit the courts' discretion to sanction litigants, "serious due process problems would result."²⁵⁸ Fee awards may also dampen counsels' ardor in presenting their clients' positions, thereby undermining the adversary system. Attorneys may be less willing to pursue novel legal theories if they are concerned about the

250. See Saxon, *supra* note 46, at 153.

251. 222 Cal. App. 3d 1568, 272 Cal. Rptr. 535 (1990).

252. *Id.* at 1574-76, 272 Cal. Rptr. at 538-40.

253. CAL. CIV. PROC. CODE § 128.5 (West Supp. 1995). The section provides, in pertinent part: "Every trial court may order a party, the party's attorney, or both to pay any reasonable expenses, including attorney's fees, incurred by another party as a result of bad-faith actions or tactics that are frivolous or solely intended to cause unnecessary delay." The California Legislature recently enacted legislation that suspends the operation of § 128.5 until January 1, 1999, substituting in its place, for a four-year trial period, a provision modeled on Rule 11 of the Federal Rules of Civil Procedure. CAL. CIV. PROC. CODE § 128.7 (West Supp. 1995).

254. See, e.g., *North Assocs. v. Bell*, 184 Cal. App. 3d 860, 865, 229 Cal. Rptr. 305, 308 (1986); *Jones v. Drain*, 149 Cal. App. 3d 484, 489-90, 196 Cal. Rptr. 827, 831 (1983).

255. See Rowe, *supra* note 13, at 660-61.

256. See *supra* text accompanying notes 36-40.

257. *Bauguess v. Paine*, 22 Cal. 3d 626, 637-38, 586 P.2d 942, 948-49, 150 Cal. Rptr. 461, 467-68 (1978). The California Legislature subsequently enacted CAL. CIV. PROC. CODE § 128.5 in 1981 to provide the statutory basis for an award of sanctions that the *Bauguess* court held were necessary. See Stats. 1981, c. 762, § 2, reprinted in CAL. CIV. PROC. CODE § 128.5, Historical Note, at 264 (West 1982).

258. *Bauguess*, 22 Cal. 3d at 638, 586 P.2d at 949, 150 Cal. Rptr. at 468.

threat of monetary sanctions against either themselves or their clients.²⁵⁹ Broad application of section 1717 to discourage frivolous litigation directly implicates these policy arguments.

Remedies for frivolous litigation tactics already exist. Courts may impose sanctions under the appropriate statutes,²⁶⁰ and a party may seek sanctions or bring a malicious prosecution action after the initial suit is over.²⁶¹ Section 1717 was not intended to be, and should not be used as, a substitute for sanctions and malicious prosecution actions.

Courts may turn to section 1717 as an alternative to these existing remedies because they are encumbered by a number of procedural hurdles making them difficult to enforce. A malicious prosecution action requires the prevailing party to bring a second, separate action in which it must prove that the plaintiff in the underlying action lacked probable cause and was motivated by malice in filing the complaint.²⁶² A litigant who has just been forced to endure years of litigation may well choose to forego a second opportunity to litigate against the same party. It also may be difficult to win such a suit because the plaintiff has the onerous task of proving malicious intent in filing the initial complaint.²⁶³ Furthermore, malicious prosecution is a disfavored cause of action and courts are hesitant to extend liability under this theory.²⁶⁴

259. *Id.*

260. In addition to CAL. CIV. PROC. CODE § 128.5 (now CAL. CIV. PROC. CODE § 128.7), sanctions are also available under CAL. CIV. PROC. CODE § 396b(b) (West Supp. 1995) for filing an action in the wrong court; under CAL. CIV. PROC. CODE § 437c (West Supp. 1995) for filing an affidavit in a summary judgment motion in bad faith; under CAL. CIV. PROC. CODE § 1038 (West Supp. 1995) for bringing a proceeding under the California Tort Claims Act or for indemnity or contribution in bad faith; under CAL. CIV. PROC. CODE § 907 (West 1980) for filing a frivolous appeal; and under CAL. CIV. PROC. CODE § 2023 (West Supp. 1995) for abuse of the discovery process. These provisions are considerably narrower in application than CAL. CIV. PROC. CODE §§ 128.5 and 128.7.

261. A malicious prosecution action is not completely analogous to a sanctions motion or § 1717 motion. A prevailing party can recover consequential damages as well as attorneys' fees in a successful malicious prosecution action. See *Babb v. Superior Court*, 3 Cal. 3d 841, 848 n.4, 479 P.2d 379, 383 n.4, 92 Cal. Rptr. 179, 183 n.4 (1971). Recourse is limited to litigation costs in both a sanctions motion under § 128.5 and in a § 1717 motion. *Brewster v. Southern Pac. Transp. Co.*, 235 Cal. App. 3d 701, 710-12, 1 Cal. Rptr. 2d 89, 94-96 (1991).

262. *Sheldon Appel Co. v. Albert & Oliker*, 47 Cal. 3d 863, 871, 765 P.2d 498, 501, 254 Cal. Rptr. 336, 340 (1989).

263. *Id.* at 871-72, 765 P.2d at 501-02, 254 Cal. Rptr. at 340.

264. See, e.g., *Babb v. Superior Court*, 3 Cal. 3d 841, 847, 479 P.2d 379, 382, 92 Cal. Rptr. 179, 182 (1971). The rationale for this disfavored status is that courts are wary

A sanctions motion also entails a difficult and time-consuming process. Due process considerations require that the sanctioned party be given notice and an opportunity to be heard before sanctions are imposed.²⁶⁵ If the aggrieved party seeks a sanctions award, she must bring a separate motion, where she must prove that the other party acted in bad faith.²⁶⁶ If the court raises the issue of sanctions on its own motion, it must give notice of its intent in order to provide the sanctioned party an opportunity to respond.²⁶⁷ As in the case of malicious prosecution, a court must find subjective bad faith in order to impose sanctions.²⁶⁸ Trial courts may be hesitant to find that litigants and attorneys appearing before them have acted in bad faith, especially when those attorneys are well known to the court.²⁶⁹

In contrast, a party entitled to recover attorneys' fees under section 1717 simply files an attorneys' fees motion when filing the costs bill.²⁷⁰ The losing party's conduct is not in issue. This is precisely why section 1717 should not be used to punish frivolous litigants. All of the procedural protections found in a sanctions motion are absent in section 1717 because the statute was not intended for punishment.²⁷¹

of the "chilling effect" that malicious prosecution actions may have on a citizen's willingness to bring a civil dispute to court or to report criminal conduct. *Sheldon Appel Co.*, 47 Cal. 3d at 872, 765 P.2d at 501-02, 254 Cal. Rptr. at 340 (1989).

265. *Caldwell v. Samuels Jewelers*, 222 Cal. App. 3d 970, 976, 272 Cal. Rptr. 126, 129-30 (1990).

266. CAL. CIV. PROC. CODE § 128.7 (West Supp. 1995).

267. *See Barrientos v. City of Los Angeles*, 30 Cal. App. 4th 63, 70, 35 Cal. Rptr. 2d 520, 524 (1994); *Bergman v. Rifkind & Sterling, Inc.*, 227 Cal. App. 3d 1380, 1387, 278 Cal. Rptr. 583, 587 (1991).

268. *See, e.g., West Coast Dev. v. Reed*, 2 Cal. App. 4th 693, 702, 3 Cal. Rptr. 2d 790, 795 (1992). Some earlier cases had held that only "objective" bad faith was required. *See, e.g., On v. Cow Hollow Properties.*, 222 Cal. App. 3d 1568, 1575, 272 Cal. Rptr. 535, 539 (1990); *Bach v. McNelis*, 207 Cal. App. 3d 852, 876, 255 Cal. Rptr. 232, 246 (1989). Other courts have subsequently criticized these cases, however. *See Javor v. Dellinger*, 2 Cal. App. 4th 1258, 1261-62, 3 Cal. Rptr. 2d 662, 664 (1992).

269. *See Crowley v. Kattelman*, 8 Cal. 4th 666, 689 n.12, 881 P.2d 1083, 1095 n.12, 34 Cal. Rptr. 2d 386, 398 n.12 (1994) (noting this phenomenon in the case before it). In addition, the fact that sanctions awards greater than \$1000 must be reported to the State Bar for possible disciplinary action pursuant to CAL. BUS. & PROF. CODE §§ 6068(o)(3) and 6086.7(c) (West Supp. 1995) may also serve as a deterrent to wider use of sanctions, especially where counsel are personally known to the presiding judge.

270. CAL. CIV. PROC. CODE § 1033.5(a)(10)(A) (West Supp. 1995) provides that attorneys' fees authorized by contract are allowable costs that may be recovered by the prevailing party. In addition, CAL. CIV. PROC. CODE § 1033.5(c)(5) (West Supp. 1995) provides, "Attorney's fees awarded pursuant to Section 1717 of the Civil Code are allowable costs under Section 1032. . . ." California Rules of Court provide the procedural guidelines for a motion for costs, including attorneys' fees. CAL. CT. R. 870(a)(1), 870.2.

271. For the due process protections required in a sanctions motion, see *supra* text accompanying notes 265-69. For the legislative intent behind § 1717, see *supra* text

While the conduct of the litigants is certainly one factor that may be included in a broad fee-shifting proposal, it is not an appropriate basis for fee-shifting in a random selection of contract actions based on the whims of the presiding judge. The Legislature may choose to pursue this idea in the future, but the courts should not do so on an ad hoc basis.²⁷² Section 1717 was not intended to be and should not be applied as such a broad departure from the American Rule.

E. Settlement

Increasing the settlement rate could also favor applying fee-shifting under section 1717 to non-signatories. Some have argued that the increased risk of paying the other side's attorneys' fees under the British Rule will lead litigants to settle at higher rates than under the American Rule.²⁷³ Thus, wider application of fee-shifting should cause a higher rate of settlement.²⁷⁴ If this argument generally supports wider fee-shifting, it should also support fee-shifting under section 1717 in cases involving contractual non-signatories.

This argument fails on two levels. On general principles, it is not clear whether the British or the American Rule is better at inducing settlement. Commentators have disagreed intensely on this point.²⁷⁵ There is no conclusive proof that the British Rule in general is better at

accompanying notes 36-40.

272. *Bauguess v. Paine*, 22 Cal. 3d 626, 637, 586 P.2d 942, 948, 150 Cal. Rptr. 461, 467 (1978) (holding that courts do not have the *power* to use fee awards as sanctions in the absence of specific statutory authorization). The California Legislature has already created a pilot program, effective until January 1, 1996, partially repealing the American Rule in Riverside and San Bernardino Counties, which incorporates this principle. If a party rejects an offer of settlement under CAL. CIV. PROC. CODE § 998 (West Supp. 1995) and thereafter becomes liable to pay a judgment less favorable than the § 998 offer, the party becomes liable to pay the prevailing parties' attorneys' fees. Among the factors courts are directed to consider in allowing fee-shifting are the good faith of the losing party in the litigation and the merits of the claim that was the subject of the action. CAL. CIV. PROC. CODE §§ 1021.1(c)(1)(A), (c)(4) (West Supp. 1995). Governor Wilson has proposed legislation to make this statute a permanent state-wide fee-shifting rule. See CALIFORNIA COMMITTEE ANALYSIS STATEMENT, BILL NO. AB 54, May 10, 1995.

273. See Donohue, *supra* note 22, at 1107-08; Smith, *supra* note 22, at 2157.

274. *Id.*

275. Compare the authorities cited *supra* note 17, arguing that the American Rule induces more settlements, and the authorities cited *supra* note 22, arguing that the British Rule is more favorable for settlement.

inducing parties to settle.²⁷⁶ Furthermore, if the British Rule does have a higher settlement rate, a disproportionate impact on the disadvantaged is the most likely cause. Poor individuals will be more risk averse because they can ill afford the chance of losing and incurring the costs of the prevailing party's attorneys' fees.²⁷⁷ This risk would deter poorer litigants from bringing an action. Rich litigants, including corporations and government institutions, could more easily bear this risk.²⁷⁸ In addition, rich litigants engaging in more litigation are better able to absorb the costs of losing because they can balance losses in some cases with wins in others.²⁷⁹ In sum, the British Rule will encourage settlement and deter the most risk averse parties from initially filing claims because the British Rule increases the risk of loss. Those more risk averse parties are likely to be poorer individuals. The least risk averse parties are likely to be large corporations. Thus, wider fee-shifting would have the opposite effect of that intended by the passage of section 1717, which was to level the playing field between individuals and large corporations.²⁸⁰ It would not encourage individuals to vindicate their claims against large corporations through the legal system. In fact, it would discourage such suits.

On the specific level of current application of the British Rule to contractual non-signatories under section 1717, uncertainty about whether fee-shifting applies will sometimes make settlement less likely than under the pure American Rule. If there is uncertainty, one litigant may assume fee-shifting will occur and incorporate this conclusion into settlement decisions, while another litigant may come to the opposite conclusion and arrive at a different calculus. For example, if plaintiff believes that the British Rule of fee-shifting applies, she will factor this into the settlement negotiations. If defendant believes that the American Rule applies, then she will not factor in the risk of having to pay

276. See Donohue, *supra* note 22, at 1094 (arguing that the rate of settlement under the British and American Rules will be identical in practice); Mause, *supra* note 11, at 31-33 (noting that effects of fee-shifting rule on settlement rates will vary with the type of case involved and that no general trend can be predicted); Thomas D. Rowe, Jr., *Predicting the Effects of Attorney Fee Shifting*, 47 LAW & CONTEMP. PROBS. 139, 154-64 (1984) (same); Snyder & Hughes, *supra* note 16, at 370-75 (noting that empirical evidence does not support the British Rule).

277. See text and authorities cited *supra* notes 233-35.

278. See POSNER, *supra* note 16, at 572; Mause, *supra* note 11, at 36; Pfennigstorf, *supra* note 13, at 77 & n.229 (noting this effect in Europe); Rowe, *supra* note 276, at 147-48; Monroe, *supra* note 19, at 165-66.

279. See Galanter, *supra* note 235, at 99-100 & n.11; Vargo, *supra* note 6, at 1596; see also *Covenant Mut. Ins. Co. v. Young*, 179 Cal. App. 3d 318, 327 n.10, 225 Cal. Rptr. 861, 867 n.10 (1986).

280. See *supra* text accompanying notes 36-40.

plaintiffs' attorneys' fees if she loses. The parties will thus make different calculations of the settlement values of their respective cases. Divergent assumptions could make settlement less likely.²⁸¹

In sum, arguments for fee-shifting in favor of contractual non-signatories under section 1717 provide only weak support for the practice. Arguments against such wide use of section 1717 are stronger.

CONCLUSION: A PROPOSAL FOR A RETURN TO PRIVACY

Judicial expansion of section 1717 into cases involving non-signatories to contracts, and especially into non-contract actions, is unmerited. Section 1717 was not intended to be, and should not be interpreted as, a general repeal of one-way fee-shifting provisions. It was explicitly designed only to eliminate one-way fee-shifting provisions found in mass consumer contracts. It was not intended to apply generally to non-signatories in contract actions, and it was certainly not intended to apply in non-contract actions.²⁸²

Inconsistent decisions based on two incoherent theories have marked application of section 1717 to non-signatories.²⁸³ Courts have applied both estoppel and mutuality theories so haphazardly that they totally lack logical consistency. No single theory can adequately explain all of the cases in which courts will find it "equitable" to award fees to a non-signatory. Thus, in some cases, third party beneficiaries have been subject to fee-shifting pursuant to section 1717, and in some cases they have not been.²⁸⁴ In some cases, non-assuming grantees of deeds of trust have been subject to fee-shifting pursuant to section 1717, and in others, they have not.²⁸⁵ Likewise, some non-signatory defendants in a contract action who prevail on the grounds that the contract is unenforceable have been subject to fee-shifting pursuant to section 1717, and

281. Others have described in detail how parties arrive at expected settlement values for their cases. The parties' calculations assume three variables: the probability of plaintiff's success at trial, the amount in controversy, and the litigation costs of both parties. Different formulae will govern the settlement value of a particular case depending on whether the American Rule or the British Rule prevails. See Donohue, *supra* note 22, at 1096-1100. See generally POSNER, *supra* note 16, at 571-74; Mause, *supra* note 11, at 54-55; Rowe, *supra* note 13, at 154-70; Shavell, *supra* note 17.

282. See *supra* text accompanying notes 186-91.

283. See *supra* text accompanying notes 192-221.

284. See *supra* text accompanying notes 200-11.

285. See *supra* text accompanying notes 123-30, 212-21.

others have not, such as when the contract is unenforceable on grounds of illegality.²⁸⁶

In short, courts have shown they will find some way to shift fees when they believe it is equitable.²⁸⁷ Judges then justify that result with a theoretical basis. On the other hand, courts will not award fees when it would appear inequitable, regardless of the theories.²⁸⁸ In order to conform results to the theory, courts have had to craft exceptions eviscerating the logic of the rules. Such a rule-making process will inevitably create gross inconsistencies and ever more Byzantine constructions of ever less plausible theories. Whenever courts simply rely on their "gut instinct" of what seems fair under the circumstances of each case, the theories used to justify such decisions will not stand up to close scrutiny. In fact, there is no theory, only judges deciding an equitable result based upon their subjective understanding of the facts. This is not the rule of law.

The inapplicability of section 1717 is particularly compelling in the case of statutory fee-shifting provisions. By passing such fee-shifting laws, the California Legislature has expressed a desire for heightened enforcement of certain statutes by members of the public.²⁸⁹ Making such one-way fee-shifting provisions reciprocal would destroy the incentive created by these fee-shifting laws. This would limit enforcement of certain statutes that the Legislature has determined are in the public interest to have vigilantly enforced.

The obvious solution to the problems with the application of section 1717 to contractual non-signatories is an amendment to section 1717 limiting its application to signatories to the contract in dispute. The following language could be inserted in paragraph (a) of the statute:

Attorneys' fees provided for by this section shall not be awarded in favor of any party not a signatory to the contract in dispute in the action. Nor shall any party not a signatory to the contract in dispute in the action be liable for such fees to the prevailing party.

This simple provision would end all fee-shifting involving contractual non-signatories under section 1717.

Some may argue that this solution is drastic and "throws the baby out with the bath water." This response assumes that fee-shifting in favor of non-signatories has overall positive effects, despite the problems

286. See *supra* text accompanying notes 166-68.

287. See *supra* text accompanying notes 96-98, 117.

288. See *supra* text accompanying notes 163-170, 208-10.

289. *Covenant Mut. Ins. Co. v. Young*, 179 Cal. App. 3d 318, 328, 225 Cal. Rptr. 861, 867-68 (1986).

associated with it. A comparison of the arguments in favor of and against such fee-shifting shows that this is not the case.

Application of section 1717 to contractual non-signatories serves no useful purpose. It does not create more equitable results; it does not effectively discourage frivolous lawsuits; it does not compensate litigants for enduring frivolous lawsuits; it does not increase the likelihood of settlement; it should not be used in place of sanctions to punish frivolous litigation tactics. Moreover, it has no basis in the statutory language or purpose; it conflicts with basic contract principles; it is based on inconsistent legal theories; it creates unpredictable and inconsistent results; it may lessen the credibility of the judicial system as a rational dispute resolution mechanism. Section 1717 should, therefore, be strictly limited to contract actions in cases in which both parties to the litigation are also parties to the contract. The proposed rule would be easily administered and produce consistent results that litigants and contracting parties can understand and upon which they can rely. In sum, such a rule would observe Voltaire's maxim as it is clear, uniform, and precise, leaving no room for corruption through interpretation.

